

VECTREN CORP  
Form 10-Q  
November 02, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended September 30, 2007**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **1-15467**

**VECTREN CORPORATION**

(Exact name of registrant as specified in its charter)

**INDIANA**

(State or other jurisdiction of incorporation or  
organization)

**35-2086905**

(IRS Employer Identification No.)

**One Vectren Square, Evansville, IN 47708**

(Address of principal executive offices)  
(Zip Code)

**812-491-4000**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Common Stock- Without Par</u>	<u>76,517,056</u>	<u>October 31, 2007</u>
<u>Value</u>		
<u>Class</u>	<u>Number of Shares</u>	<u>Date</u>

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**Access to Information**

Vectren Corporation makes available all SEC filings and recent annual reports free of charge, including those of its wholly owned subsidiaries, through its website at [www.vectren.com](http://www.vectren.com), or by request, directed to Investor Relations at the mailing address, phone number, or email address that follows:

Mailing Address:	Phone Number:	Investor Relations Contact:
One Vectren Square	(812) 491-4000	Steven M. Schein
Evansville, Indiana 47708		Vice President, Investor Relations
		<a href="mailto:sschein@vectren.com">sschein@vectren.com</a>

**Definitions**

AFUDC: allowance for funds used during construction	MMBTU: millions of British thermal units
APB: Accounting Principles Board	MW: megawatts
EITF: Emerging Issues Task Force	MWh / GWh: megawatt hours / thousands of megawatt hours (gigawatt hours)
FASB: Financial Accounting Standards Board	NOx: nitrogen oxide
FERC: Federal Energy Regulatory Commission	OCC: Ohio Office of the Consumer Counselor

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IDEM: Indiana Department of Environmental Management      OUCC: Indiana Office of the Utility Consumer Counselor

IURC: Indiana Utility Regulatory Commission      PUCO: Public Utilities Commission of Ohio

MCF / BCF: thousands / billions of cubic feet      SFAS: Statement of Financial Accounting Standards

MDth / MMDth: thousands / millions of dekatherms      USEPA: United States Environmental Protection Agency

MISO: Midwest Independent System Operator      Throughput: combined gas sales and gas transportation volumes

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**VECTREN CORPORATION AND SUBSIDIARY COMPANIES**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
*(Unaudited – In millions)*

	September 30, 2007	December 31, 2006
<b><u>ASSETS</u></b>		
Current Assets		
Cash & cash equivalents	\$ 11.2	\$ 32.8
Accounts receivable - less reserves of \$3.7 & \$3.3, respectively	145.2	198.6
Accrued unbilled revenues	60.7	146.5
Inventories	198.8	163.5
Recoverable fuel & natural gas costs	-	1.8
Prepayments & other current assets	132.1	172.7
<b>Total current assets</b>	<b>548.0</b>	<b>715.9</b>
Utility Plant		
Original cost	3,990.8	3,820.2
Less: accumulated depreciation & amortization	1,499.1	1,434.7
<b>Net utility plant</b>	<b>2,491.7</b>	<b>2,385.5</b>
Investments in unconsolidated affiliates	194.5	181.0
Other investments	73.0	74.5
Nonutility property - net	312.9	294.4
Goodwill - net	238.0	237.8
Regulatory assets	184.8	163.5
Other assets	37.9	39.0
<b>TOTAL ASSETS</b>	<b>\$ 4,080.8</b>	<b>\$ 4,091.6</b>

The accompanying notes are an integral part of these consolidated condensed financial statements.

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**VECTREN CORPORATION AND SUBSIDIARY COMPANIES**  
**CONSOLIDATED CONDENSED BALANCE SHEETS**  
*(Unaudited – In millions)*

	September 30, 2007	December 31, 2006
<b><u>LIABILITIES &amp; SHAREHOLDERS' EQUITY</u></b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 164.8	\$ 180.0
Accounts payable to affiliated companies	33.7	89.9
Refundable fuel & natural gas costs	25.9	35.3
Accrued liabilities	151.0	147.2
Short-term borrowings	486.7	464.8
Current maturities of long-term debt	17.8	24.2
Long-term debt subject to tender	20.0	20.0
<b>Total current liabilities</b>	<b>899.9</b>	<b>961.4</b>
<b>Long-term Debt - Net of Current Maturities &amp; Debt Subject to Tender</b>		
	<b>1,208.3</b>	<b>1,208.0</b>
<b>Deferred Income Taxes &amp; Other Liabilities</b>		
Deferred income taxes	256.6	260.7
Regulatory liabilities	303.1	291.1
Deferred credits & other liabilities	199.8	195.8
<b>Total deferred credits &amp; other liabilities</b>	<b>759.5</b>	<b>747.6</b>
Minority Interest in Subsidiary	0.4	0.4
<b>Commitments &amp; Contingencies (Notes 8, 10-12)</b>		
<b>Common Shareholders' Equity</b>		
Common stock (no par value) – issued & outstanding		
76.5 and 76.1 shares, respectively	531.7	525.5
Retained earnings	674.2	643.6
Accumulated other comprehensive income	6.8	5.1
<b>Total common shareholders' equity</b>	<b>1,212.7</b>	<b>1,174.2</b>
<b>TOTAL LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>	<b>\$ 4,080.8</b>	<b>\$ 4,091.6</b>

The accompanying notes are an integral part of these consolidated condensed financial statements.

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**VECTREN CORPORATION AND SUBSIDIARY COMPANIES**  
**CONSOLIDATED CONDENSED STATEMENTS OF INCOME**  
*(Unaudited – In millions, except per share data)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>OPERATING REVENUES</b>				
Gas utility revenues	\$ 114.0	\$ 116.8	\$ 890.0	\$ 848.6
Electric utility revenues	143.6	123.2	361.6	324.4
Nonutility revenues	123.8	100.5	385.5	259.5
<b>Total operating revenues</b>	<b>381.4</b>	<b>340.5</b>	<b>1,637.1</b>	<b>1,432.5</b>
<b>OPERATING EXPENSES</b>				
Cost of gas sold	52.9	59.9	592.0	577.4
Cost of fuel & purchased power	50.5	46.8	129.5	115.8
Cost of nonutility revenues	57.5	48.8	210.2	174.8
Other operating	116.4	101.8	334.4	242.9
Depreciation & amortization	47.3	44.0	139.7	127.5
Taxes other than income taxes	11.7	10.8	50.9	45.7
Total operating expenses	336.3	312.1	1,456.7	1,284.1
<b>OPERATING INCOME</b>	<b>45.1</b>	<b>28.4</b>	<b>180.4</b>	<b>148.4</b>
<b>OTHER INCOME - NET</b>				
Equity in earnings (losses) of unconsolidated affiliates	(4.0)	3.2	18.7	14.7
Other income (loss) – net	13.9	1.6	23.1	(4.5)
Total other income - net	9.9	4.8	41.8	10.2
Interest expense	25.7	24.2	74.1	69.9
<b>INCOME BEFORE INCOME TAXES</b>	<b>29.3</b>	<b>9.0</b>	<b>148.1</b>	<b>88.7</b>
Income taxes	12.2	(3.0)	44.9	14.8
<b>NET INCOME</b>	<b>\$ 17.1</b>	<b>\$ 12.0</b>	<b>\$ 103.2</b>	<b>\$ 73.9</b>
<b>AVERAGE COMMON SHARES OUTSTANDING</b>				
	<b>75.9</b>	<b>75.7</b>	<b>75.9</b>	<b>75.7</b>
<b>DILUTED COMMON SHARES OUTSTANDING</b>				
	<b>76.4</b>	<b>76.0</b>	<b>76.5</b>	<b>76.0</b>
<b>EARNINGS PER SHARE OF COMMON STOCK:</b>				
<b>BASIC</b>	<b>\$ 0.23</b>	<b>\$ 0.16</b>	<b>\$ 1.36</b>	<b>\$ 0.98</b>
<b>DILUTED</b>	<b>0.22</b>	<b>0.16</b>	<b>1.35</b>	<b>0.97</b>
<b>DIVIDENDS DECLARED PER SHARE OF COMMON STOCK</b>				
	<b>\$ 0.32</b>	<b>\$ 0.31</b>	<b>\$ 0.95</b>	<b>\$ 0.92</b>

The accompanying notes are an integral part of these consolidated condensed financial statements.



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**VECTREN CORPORATION AND SUBSIDIARY COMPANIES**  
**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
*(Unaudited – In millions)*

	Nine Months Ended September 30,	
	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 103.2	\$ 73.9
Adjustments to reconcile net income to cash from operating activities:		
Depreciation & amortization	139.7	127.5
Deferred income taxes & investment tax credits	18.0	(1.6)
Equity in earnings of unconsolidated affiliates	(18.7)	(14.7)
Provision for uncollectible accounts	12.7	12.4
Expense portion of pension & postretirement periodic benefit cost	7.3	8.1
Other non-cash charges - net	-	10.3
Changes in working capital accounts:		
Accounts receivable & accrued unbilled revenue	126.5	279.1
Inventories	(35.3)	(43.0)
Recoverable/refundable fuel & natural gas costs	(7.6)	31.9
Prepayments & other current assets	2.5	(29.7)
Accounts payable, including to affiliated companies	(74.3)	(146.1)
Accrued liabilities	(15.0)	(42.0)
Unconsolidated affiliate dividends	20.0	33.5
Changes in noncurrent assets	(13.5)	(20.7)
Changes in noncurrent liabilities	(33.3)	(15.3)
<b>Net cash flows from operating activities</b>	<b>232.2</b>	<b>263.6</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from:		
Stock option exercises	5.2	-
Long-term debt	-	0.1
Requirements for:		
Dividends on common stock	(71.8)	(69.3)
Retirement of long-term debt	(6.6)	(0.4)
Other financing activities	-	(0.4)
Net change in short-term borrowings	21.9	32.3
<b>Net cash flows from financing activities</b>	<b>(51.3)</b>	<b>(37.7)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Proceeds from:		
Unconsolidated affiliate distributions	11.7	1.9
Other collections	37.3	2.9
Requirements for:		
Capital expenditures, excluding AFUDC equity	(239.0)	(185.9)
Unconsolidated affiliate investments	(12.4)	(16.7)
Other investments	(0.1)	(41.9)
<b>Net cash flows from investing activities</b>	<b>(202.5)</b>	<b>(239.7)</b>
Net decrease in cash & cash equivalents	(21.6)	(13.8)

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Cash & cash equivalents at beginning of period		32.8		20.4
Cash & cash equivalents at end of period		\$ 11.2	\$	6.6

The accompanying notes are an integral part of these consolidated condensed financial statements.

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**VECTREN CORPORATION AND SUBSIDIARY COMPANIES  
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
(UNAUDITED)**

**1. Organization and Nature of Operations**

Vectren Corporation (the Company or Vectren), an Indiana corporation, is an energy holding company headquartered in Evansville, Indiana. The Company's wholly owned subsidiary, Vectren Utility Holdings, Inc. (Utility Holdings), serves as the intermediate holding company for three operating public utilities: Indiana Gas Company, Inc. (Indiana Gas), Southern Indiana Gas and Electric Company (SIGECO), and the Ohio operations. Utility Holdings also has other assets that provide information technology and other services to the three utilities. Utility Holdings' consolidated operations are collectively referred to as the Utility Group. Vectren and Utility Holdings are holding companies as defined by the Energy Policy Act of 2005.

Indiana Gas provides energy delivery services to approximately 565,000 natural gas customers located in central and southern Indiana. SIGECO provides energy delivery services to approximately 141,000 electric customers and approximately 112,000 gas customers located near Evansville in southwestern Indiana. SIGECO also owns and operates electric generation to serve its electric customers and optimizes those assets in the wholesale power market. Indiana Gas and SIGECO generally do business as Vectren Energy Delivery of Indiana. The Ohio operations provide energy delivery services to approximately 318,000 natural gas customers located near Dayton in west central Ohio. The Ohio operations are owned as a tenancy in common by Vectren Energy Delivery of Ohio, Inc. (VEDO), a wholly owned subsidiary, (53% ownership) and Indiana Gas (47% ownership). The Ohio operations generally do business as Vectren Energy Delivery of Ohio.

The Company, through Vectren Enterprises, Inc. (Enterprises), is also involved in nonutility activities in three primary business areas: Energy Marketing and Services, Coal Mining and Energy Infrastructure Services. Energy Marketing and Services markets and supplies natural gas and provides energy management services. Coal Mining mines and sells coal. Energy Infrastructure Services provides underground construction and repair and energy performance contracting services. Enterprises also has other businesses that invest in energy-related opportunities and services, real estate, and leveraged leases, among other investments. In addition, the Company has investments that generate synfuel tax credits and processing fees relating to the production of coal-based synthetic fuels. These operations are collectively referred to as the Nonutility Group. Enterprises supports the Company's regulated utilities pursuant to service contracts by providing natural gas supply services, coal, infrastructure services, and other services.

**2. Basis of Presentation**

The interim consolidated condensed financial statements included in this report have been prepared by the Company, without audit, as provided in the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted as provided in such rules and regulations. The Company believes that the information in this report reflects all adjustments necessary to fairly state the results of the interim periods reported. These consolidated condensed financial statements and related notes should be read in conjunction with the Company's audited annual consolidated financial statements for the year ended December 31, 2006, filed February 16, 2007, on Form 10-K. Because of the seasonal nature of the Company's utility operations, the results shown on a quarterly basis are not necessarily indicative of annual results.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statements and the reported amounts of

revenues and expenses during the reporting periods. Actual results could differ from those estimates.

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Table of Contents**3. Comprehensive Income**

Comprehensive income consists of the following:

<i>(In millions)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
Net income	\$ 17.1	\$ 12.0	\$ 103.2	\$ 73.9
Comprehensive income (loss)				
of unconsolidated affiliates	1.3	10.5	3.1	(1.6)
Cash flow hedges				
Unrealized gains	(0.6)	(1.1)	0.2	(4.0)
Reclassifications to net income	(0.1)	(0.1)	(0.6)	(2.2)
Income tax benefit (expense)	(0.2)	(3.8)	(1.0)	2.8
<b>Total comprehensive income</b>	<b>\$ 17.5</b>	<b>\$ 17.5</b>	<b>\$ 104.9</b>	<b>\$ 68.9</b>

Other comprehensive income of unconsolidated affiliates is the Company's portion of ProLiance Energy, LLC's accumulated other comprehensive income related to their use of cash flow hedges, including commodity contracts, and the Company's portion of Haddington Energy Partners, LP's accumulated other comprehensive income related to its unrealized gains and losses of "available for sale securities," as defined by SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities."

**4. Earnings Per Share**

Basic earnings per share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share assumes the conversion of stock options into common shares and settlement in shares of an equity forward contract (see Note 9), using the treasury stock method, as well as the conversion of restricted shares using the contingently issuable shares method, to the extent the effect would be dilutive.

The following table sets forth the computation of basic and diluted earnings per share.

<i>(In millions, except per share data)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
<b>Numerator:</b>				
Numerator for basic and diluted EPS - Net income	\$ 17.1	\$ 12.0	\$ 103.2	\$ 73.9
<b>Denominator:</b>				
Denominator for basic EPS - Weighted average common shares outstanding	75.9	75.7	75.9	75.7
Equity forward dilution effect	-	-	0.1	-
Conversion of stock options and lifting of restrictions on issued restricted stock	0.5	0.3	0.5	0.3
Denominator for diluted EPS - Adjusted weighted average shares outstanding and assumed conversions outstanding	76.4	76.0	76.5	76.0
<b>Basic earnings per share</b>	<b>\$ 0.23</b>	<b>\$ 0.16</b>	<b>\$ 1.36</b>	<b>\$ 0.98</b>
<b>Diluted earnings per share</b>	<b>\$ 0.22</b>	<b>\$ 0.16</b>	<b>\$ 1.35</b>	<b>\$ 0.97</b>

For the three and nine months ended September 30, 2007 and 2006, all options were dilutive.

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Table of Contents**5. Excise and Utility Receipts Taxes**

Excise taxes and a portion of utility receipts taxes are included in rates charged to customers. Accordingly, the Company records these taxes received as a component of operating revenues, which totaled \$4.9 million and \$4.7 million, respectively for the three months ended September 30, 2007 and 2006. For the nine months ended September 30, 2007 and 2006, these taxes totaled \$29.6 million and \$27.9 million, respectively. Expenses associated with excise and utility receipts taxes are recorded as a component of *Taxes other than income taxes*.

**6. Retirement Plans & Other Postretirement Benefits**

The Company maintains three qualified defined benefit pension plans, a nonqualified supplemental executive retirement plan (SERP), and three other postretirement benefit plans. The qualified pension plans and the SERP are aggregated under the heading "Pension Benefits." Other postretirement benefit plans are aggregated under the heading "Other Benefits."

Net Periodic Benefit Cost

A summary of the components of net periodic benefit cost follows:

<i>(In millions)</i>	Three Months Ended September 30,			
	Pension Benefits		Other Benefits	
	2007	2006	2007	2006
Service cost	\$ 1.4	\$ 1.5	\$ 0.1	\$ 0.1
Interest cost	3.7	3.5	1.0	0.9
Expected return on plan assets	(3.6)	(3.4)	(0.1)	(0.1)
Amortization of prior service cost	0.4	0.5	(0.2)	(0.2)
Amortization of transitional obligation	-	-	0.3	0.3
Amortization of actuarial loss	0.4	0.6	-	-
<b>Net periodic benefit cost</b>	<b>\$ 2.3</b>	<b>\$ 2.7</b>	<b>\$ 1.1</b>	<b>\$ 1.0</b>

<i>(In millions)</i>	Nine Months Ended September 30,			
	Pension Benefits		Other Benefits	
	2007	2006	2007	2006
Service cost	\$ 4.2	\$ 4.5	\$ 0.3	\$ 0.4
Interest cost	11.1	10.6	3.0	2.9
Expected return on plan assets	(10.8)	(10.1)	(0.3)	(0.4)
Amortization of prior service cost	1.2	1.3	(0.6)	(0.6)
Amortization of transitional obligation	-	-	0.9	0.8
Amortization of actuarial loss	1.2	1.8	-	-
<b>Net periodic benefit cost</b>	<b>\$ 6.9</b>	<b>\$ 8.1</b>	<b>\$ 3.3</b>	<b>\$ 3.1</b>

Employer Contributions to Qualified Pension Plans

Currently, the Company expects to contribute approximately \$17.4 million to its pension plan trusts for 2007. During the nine months ended September 30, 2007, contributions of \$15.2 million have been made to the pension plan trusts.

**7. Transactions with ProLiance Energy, LLC**

ProLiance Energy, LLC (ProLiance), a nonutility energy marketing affiliate of Vectren and Citizens Gas and Coke Utility (Citizens Gas), provides services to a broad range of municipalities, utilities, industrial operations, schools, and

healthcare institutions located throughout the Midwest and Southeast United States. ProLiance's primary customers include Vectren's Indiana utilities and nonutility gas supply operations as well as Citizens Gas. ProLiance's businesses include gas marketing, gas portfolio optimization, and other portfolio and energy management services. Consistent with its ownership percentage, Vectren is allocated 61% of ProLiance's profits and losses; however, governance and voting rights remain at 50% for each member; and therefore, the Company accounts for its investment in ProLiance using the equity method of accounting.

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The Company, including its nonutility retail gas supply operations, contracted for approximately 75% and 76% of its natural gas purchases through ProLiance during the nine months ended September 30, 2007 and 2006, respectively. Purchases from ProLiance for resale and for injections into storage for the three months ended September 30, 2007 and 2006 totaled \$138.4 million and \$130.5 million, respectively, and for the nine months ended September 30, 2007 and 2006, totaled \$584.7 million and \$573.8 million, respectively. Amounts owed to ProLiance at September 30, 2007, and December 31, 2006, for those purchases were \$34.5 million and \$84.8 million, respectively, and are included in *Accounts payable to affiliated companies*. Amounts charged by ProLiance for gas supply services are established by supply agreements with each utility.

Summarized Financial Information

Summarized financial information related to ProLiance is presented below:

<i>(in millions)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
Summarized Statement of Income information:				
Revenues	\$ 423.9	\$ 422.1	\$ 1,687.7	\$ 1,896.1
Margin	10.5	16.6	74.6	72.4
Operating income (loss)	0.7	(10.0)	50.6	28.8
ProLiance's earnings (loss)	1.8	(8.1)	55.4	31.0

<i>(In millions)</i>	As of September 30,	As of December 31,
	2007	2006
Summarized balance sheet information:		
Current assets	\$ 489.5	\$ 652.4
Noncurrent assets	41.4	41.5
Current liabilities	257.2	452.2
Noncurrent liabilities	9.3	5.7
Equity	264.4	236.0

Vectren's share of ProLiance's operating results, which are included on a pretax basis in *Equity in earnings of unconsolidated affiliates*, were \$1.1 million and \$5.2 million, respectively, for the three months ended September 30, 2007 and 2006 and \$33.8 million and \$29.1 million year to date at September 30, 2007 and 2006, respectively. Vectren's share of ProLiance's earnings, after income taxes and allocated interest expense, was a loss of \$0.2 million and earnings of \$2.4 million for the three months ended September 30, 2007 and 2006, respectively, and was earnings of \$17.6 million and \$14.9 million for the nine months ended September 30, 2007 and 2006, respectively.

## 8. Synfuel-Related Activity

Pace Carbon Synfuels, LP (Pace Carbon) is a Delaware limited partnership formed to develop, own, and operate four projects to produce and sell coal-based synthetic fuel (synfuel) utilizing Covol technology. The Company has an 8.3 percent interest in Pace Carbon which is accounted for using the equity method of accounting. The Internal Revenue Code provides for manufacturers, such as Pace Carbon, to receive a tax credit for every ton of synthetic fuel sold. Under current tax laws, these synfuel-related credits and fees cease at the end of 2007.

The Internal Revenue Service has issued private letter rulings, which concluded that the synthetic fuel produced at the Pace Carbon facilities should qualify for tax credits. The IRS has completed tax audits of Pace Carbon for the years 1998 through 2001 without challenging tax credit calculations. As a partner in Pace Carbon, Vectren has reflected synfuel tax credits in its consolidated results from inception through September 30, 2007, of approximately \$119

million, of which approximately \$108 million have been generated since 2001. To date, Vectren has been in a position to utilize or carryforward substantially all of the credits generated. Primarily from the use of these credits, the Company has an Alternative Minimum Tax (AMT) credit carryforward of approximately \$42 million at September 30, 2007.

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Synfuel tax credits are only available when the price of oil is less than a base price specified by the Internal Revenue Code, as adjusted for inflation. The current forward price curve indicates that a phase out of synfuel tax credits in 2007 may occur. However, in the fourth quarter of 2006, the Company purchased oil contracts with a notional amount of 2.8 million barrels, which approximates the Company's expected 2007 synfuel production, to mitigate 2007 phase out risk. During the three and nine months ended September 30, 2007, the mark-to-market gains associated with these contracts totaled \$8.2 million and \$6.9 million, respectively, and are reflected in *Other-net*. Impairment charges relating to the investment in Pace Carbon approximating \$9.5 million, or \$5.7 million after tax, were recorded in *Other-net* in the second quarter of 2006.

The investment in Pace Carbon resulted in losses reflected in *Equity in earnings of unconsolidated affiliates* totaling \$5.6 million and \$2.0 million for the three months ended September 30, 2007 and 2006, respectively, and \$16.1 million and \$14.0 million during the nine months ended September 30, 2007 and 2006, respectively. Synfuel related results, inclusive of those losses and their related tax benefits as well as the tax credits and other related activity, were earnings of \$3.5 million and \$8.3 million, respectively, for the three and nine months ended September 30, 2007, respectively, compared to earnings of \$0.6 million and losses of \$3.7 million, respectively, during the three and nine months ended September 30, 2006.

## **9. Common Stock Offering**

In February 2007, the Company sold 4.6 million authorized but previously unissued shares of its common stock to a group of underwriters in an SEC-registered primary offering at a price of \$28.33 per share. The transaction generated proceeds, net of underwriting discounts and commissions, of approximately \$125.7 million. The Company executed an equity forward sale agreement (equity forward) in connection with the offering, and therefore, did not receive proceeds at the time of the equity offering. The equity forward allows the Company to price an offering under market conditions existing at that time, and to better match the receipt of the offering proceeds and the associated share dilution with the implementation of regulatory initiatives, providing a return on the new equity employed. The offering proceeds, when and if received, will be used to permanently finance primarily electric utility capital expenditures.

In connection with the equity forward, an affiliate of one of the underwriters (the forward seller), at the Company's request, borrowed an equal number of shares of the Company's common stock from institutional stock lenders and sold those borrowed shares to the public in the primary offering. The Company will receive an amount equal to the net proceeds from that sale, subject to certain adjustments defined in the equity forward, upon full share settlement of the equity forward. Those adjustments defined in the equity forward include 1) daily increases in the forward sale price based on a floating interest factor equal to the federal funds rate, less a 35 basis point fixed spread, and 2) structured quarterly decreases to the forward sale price that align with expected Company dividend payments.

The Company may elect to settle the equity forward in shares or in cash, except in specified circumstances or events where the counterparty to the equity forward could force a share settlement. Examples of such events include, but are not limited to, the Company making dividend payments greater than the structured quarterly decreases identified in the equity forward or the Company repurchasing a number of its outstanding common shares over a specified threshold. If the Company elects to settle in shares, the maximum number of shares deliverable by the Company is 4.6 million shares. If the Company elects to settle in cash, an affiliate of one of the underwriters (the forward purchaser) would purchase shares in the market and return those shares to the stock lenders. The Company will either owe or be owed funds depending upon the Company's average share price during the "unwind period" defined in the equity forward in relation to the equity forward's contracted price. Generally, if the equity forward's contracted price is lower than average share price during the "unwind period", then the Company would owe cash; and if the average share price during the "unwind period" is less than the equity forward's contracted price, the Company would receive cash. Proceeds received or paid when the equity forward is settled will be recorded in *Common Shareholders' Equity*, even if settled in cash. The equity forward must be settled prior to February 28, 2009.



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The equity forward had an initial forward price of \$27.34 per share, representing the public offering price of \$28.33 per share, net of underwriting discounts and commissions. Management therefore estimated the contract had no initial fair value. If the equity forward had been settled by delivery of shares at September 30, 2007, the Company would have received approximately \$126.5 million based on a forward price of \$27.50 for the 4.6 million shares. If the Company had elected to settle the equity forward in cash at September 30, 2007, the Company estimates it would have received approximately \$3 million, assuming the price in the “unwind period” approximates the trailing three month average of Vectren’s stock price. The federal funds rate was 5.25% at September 30, 2007. The Company currently anticipates settling the equity forward by delivering shares.

## **10. Commitments & Contingencies**

### Legal Proceedings

The Company is party to various legal proceedings arising in the normal course of business. In the opinion of management, there are no legal proceedings pending against the Company that are likely to have a material adverse effect on its financial position, results of operations or cash flows.

### Guarantees & Product Warranties

Vectren issues guarantees to third parties on behalf of its unconsolidated affiliates. Such guarantees allow those affiliates to execute transactions on more favorable terms than the affiliate could obtain without such a guarantee. Guarantees may include posted letters of credit, leasing guarantees, and performance guarantees. As of September 30, 2007, guarantees issued and outstanding on behalf of unconsolidated affiliates approximated \$3 million. The Company has accrued no liabilities for these guarantees as they relate to guarantees issued among related parties.

In 2006, the Company issued a guarantee with an approximate \$5 million maximum risk related to the residual value of an operating lease that expires in 2011. As of September 30, 2007, Vectren Corporation has a liability representing the fair value of that guarantee of less than \$0.1 million. Liabilities accrued for, and activity related to, product warranties are not significant.

## **11. Environmental Matters**

### Clean Air/Climate Change

In March of 2005 USEPA finalized two new air emission reduction regulations. The Clean Air Interstate Rule (CAIR) is an allowance cap and trade program requiring further reductions in Nitrogen Oxides (NO<sub>x</sub>) and Sulfur Dioxide (SO<sub>2</sub>) emissions from coal-burning power plants. The Clean Air Mercury Rule (CAMR) is an allowance cap and trade program requiring further reductions in mercury emissions from coal-burning power plants. Both sets of regulations require emission reductions in two phases. The first phase deadline for both rules is 2010 (2009 for NO<sub>x</sub> under CAIR), and the second phase deadline for compliance with the emission reductions required under CAIR is 2015, while the second phase deadline for compliance with the emission reduction requirements of CAMR is 2018. The Company is evaluating compliance options and fully expects to be in compliance by the required deadlines.

In February 2006, the IURC approved a multi-emission compliance plan filed by the Company’s utility subsidiary, SIGECO. Once the plan is implemented, SIGECO’s coal-fired plants will be 100% scrubbed for SO<sub>2</sub>, 90% scrubbed for NO<sub>x</sub>, and mercury emissions will be reduced to meet the new mercury reduction standards. The order, as previously agreed to by the OUCC and Citizens Action Coalition, allows SIGECO to recover an approximate 8% return on up to \$110 million in capital investments through a rider mechanism which is updated every six months for actual costs incurred. The Company may file periodic updates with the IURC requesting modification to the spending authority. The Company will also recover through a rider its operating expenses, including depreciation, once the equipment is placed into service. As of September 30, 2007, the Company has made capital investments of approximately \$91 million related to this environmental requirement. Of that amount, \$49.4 million was placed into

service on January 1, 2007 and was included in rate base for purposes of determining new base rates that went into effect on August 15, 2007 (See Note 12).

If legislation requiring reductions in carbon dioxide and other greenhouse gases is adopted, such regulation could substantially affect both the costs and operating characteristics of the Company's fossil fuel generating plants and nonutility coal mining operations. At this time and in absence of final legislation, compliance costs and other effects associated with reductions in greenhouse gas emissions remain uncertain.

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Pursuant to an IURC order, SIGECO is studying renewable energy alternatives, and on April 9, 2007, filed a green power rider in order to allow customers to purchase green power and is also seeking approval of a contract to purchase 30 MW of power generated by wind energy. Future filings with the IURC with regard to new generation and/or further environmental compliance plans will include evaluation of potential carbon requirements.

### Environmental Remediation Efforts

In the past, Indiana Gas, SIGECO, and others operated facilities for the manufacture of gas. Given the availability of natural gas transported by pipelines, these facilities have not been operated for many years. Under currently applicable environmental laws and regulations, those that operated these facilities may now be required to take remedial action if certain contaminants are found above the regulatory thresholds at these sites.

Indiana Gas identified the existence, location, and certain general characteristics of 26 gas manufacturing and storage sites for which it may have some remedial responsibility. Indiana Gas completed a remedial investigation/feasibility study (RI/FS) at one of the sites under an agreed order between Indiana Gas and the IDEM, and a Record of Decision was issued by the IDEM in January 2000. Although Indiana Gas has not begun an RI/FS at additional sites, Indiana Gas has submitted several of the sites to the IDEM's Voluntary Remediation Program (VRP) and is currently conducting some level of remedial activities, including groundwater monitoring at certain sites, where deemed appropriate, and will continue remedial activities at the sites as appropriate and necessary.

Indiana Gas accrued the estimated costs for further investigation, remediation, groundwater monitoring, and related costs for the sites. While the total costs that may be incurred in connection with addressing these sites cannot be determined at this time, Indiana Gas has recorded costs that it reasonably expects to incur totaling approximately \$20.4 million.

The estimated accrued costs are limited to Indiana Gas' share of the remediation efforts. Indiana Gas has arrangements in place for 19 of the 26 sites with other potentially responsible parties (PRP), which serve to limit Indiana Gas' share of response costs at these 19 sites to between 20% and 50%. With respect to insurance coverage, Indiana Gas has received and recorded settlements from all known insurance carriers under insurance policies in effect when these plants were in operation in an aggregate amount approximating \$20.4 million.

In October 2002, SIGECO received a formal information request letter from the IDEM regarding five manufactured gas plants that it owned and/or operated and were not enrolled in the IDEM's VRP. In October 2003, SIGECO filed applications to enter four of the manufactured gas plant sites in IDEM's VRP. The remaining site is currently being addressed in the VRP by another Indiana utility. SIGECO added those four sites into the renewal of the global Voluntary Remediation Agreement that Indiana Gas has in place with IDEM for its manufactured gas plant sites. That renewal was approved by the IDEM in February 2004. SIGECO is also named in a lawsuit filed in federal district court in May 2007, involving another site subject to potential environmental remediation efforts.

SIGECO has filed a declaratory judgment action against its insurance carriers seeking a judgment finding its carriers liable under the policies for coverage of further investigation and any necessary remediation costs that SIGECO may accrue under the VRP program and/or related to the site subject to the May 2007 lawsuit. While the total costs that may be incurred in connection with addressing these sites cannot be determined at this time, SIGECO has recorded costs that it reasonably expects to incur totaling approximately \$7.7 million. With respect to insurance coverage, SIGECO has received and recorded settlements from insurance carriers under insurance policies in effect when these sites were in operation in an aggregate amount approximating the costs it expects to incur.

Environmental remediation costs related to Indiana Gas' and SIGECO's manufactured gas plants and other sites have had no material impact on results of operations or financial condition since costs recorded to date approximate PRP and insurance settlement recoveries. While the Company's utilities have recorded all costs which they presently expect to incur in connection with activities at these sites, it is possible that future events may require some level of

additional remedial activities which are not presently foreseen and those costs may not be subject to PRP or insurance recovery.

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**12. Rate & Regulatory Matters**

Vectren South (SIGECO) Electric Base Rate Order Received

On August 15, 2007, the Company received an order from the IURC which approved a settlement agreement with the OUCC and other interveners regarding the proposed changes to the base rates and charges for its electric distribution business in southwestern Indiana. The settlement agreement provides for an approximate \$60.8 million electric rate increase to cover the Company's cost of system growth, maintenance, safety and reliability. The settlement provides for, among other things: recovery of ongoing costs and deferred costs associated with the MISO; operations and maintenance (O&M) expense increases related to managing the aging workforce, including the development of expanded apprenticeship programs and the creation of defined training programs to ensure proper knowledge transfer, safety and system stability; increased O&M expense necessary to maintain and improve system reliability; benefit to customers from the sale of wholesale power by Vectren sharing evenly with customers any profit earned above or below \$10.5 million of wholesale power margin; recovery of and return on the investment in past demand side management programs to help encourage conservation during peak load periods; timely recovery of the Company's investment in certain new electric transmission projects that benefit the MISO infrastructure outside of the Company's service territory an overall rate of return of 7.32 percent on rate base of approximately \$1,044 million and an allowed return on equity (ROE) of 10.4 percent.

Vectren South (SIGECO) Gas Base Rate Order Received

On August 1, 2007, the Company received an order from the IURC which approved, with a minor modification, the settlement agreement previously reached with the Indiana Office of the Utility Consumer Counselor (OUCC) and other interveners regarding its Vectren South gas rate case. The order provided for a base rate increase of \$5.1 million and an ROE of 10.15 percent, with an overall rate of return of 7.20 percent on rate base of approximately \$122 million. The order also includes removal of \$2.6 million of costs from base rates to be recovered through existing tracking mechanisms.

Further, additional expenditures for a multi-year bare steel and cast iron capital replacement program will be afforded certain accounting treatment that mitigates earnings attrition from the investment between rate cases. The accounting treatment allows for the continuation of the accrual for allowance for funds used during construction (AFUDC) and the deferral of depreciation expense after the projects go in service but before they are included in base rates. To qualify for this treatment, the annual expenditures are limited to \$3.0 million and the treatment cannot extend beyond three years on each project.

With this order, the company now has in place for its South gas territory weather normalization, a conservation and decoupling tariff, tracking of gas cost expense related to bad debts and unaccounted for gas through the existing gas cost adjustment mechanism, and tracking of pipeline integrity expense.

Vectren North (Indiana Gas Company, Inc.) Gas Base Rate Filing

In May 2007, the Company filed a petition with the IURC to adjust its gas base rates and charges in its North service territory. The petition requests an increase of approximately \$41 million in rates to recover the ongoing cost of operating, maintaining and expanding the approximately 12,000-mile distribution and storage system used to serve more than 565,000 natural gas customers. Components of the requested increase include return on additional utility infrastructure investment, costs associated with federally mandated pipeline integrity management, inspection and other reliability programs, and aging workforce. A hearing on the Company's request before the IURC was held in late August 2007 and the final hearing is scheduled for December 2007. The Company expects an order from the IURC in the second quarter of 2008.

Vectren Energy Delivery of Ohio, Inc. (VEDO) Filing of Pre-Filing Notice

In September 2007, the Company issued a pre-filing notice with the PUCO indicating it plans to request an increase in its base rate charges for VEDO's distribution business in its 17-county service area in west central Ohio. The filing

indicates that an increase in base rates of approximately \$29 million is necessary to cover the ongoing cost of operating, maintaining and expanding the approximately 5,200-mile distribution system used to serve 318,000 customers. Components of the requested increase include return on additional utility infrastructure investment, costs associated with federally mandated pipeline integrity management, inspection and other reliability programs, and aging workforce.

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In addition, the Company is seeking extension of the decoupling mechanisms currently in place to encourage customer conservation and also is seeking approval of expanded conservation-oriented programs, such as rebate offerings on high-efficiency natural gas appliances for existing and new home construction, to help customers lower their natural gas bills.

### Ohio and Indiana Lost Margin Recovery/Conservation Filings

In 2005, the Company filed conservation programs and conservation adjustment trackers in Indiana and Ohio designed to help customers conserve energy and reduce their annual gas bills. The programs allow the Company to recover costs of promoting the conservation of natural gas through conservation trackers that work in tandem with a lost margin recovery mechanism. These mechanisms are designed to allow the Company to recover the distribution portion of its rates from residential and commercial customers based on the level of customer revenues established in each utility's last general rate case.

#### *Indiana*

In December 2006, the IURC approved a settlement agreement that provides for a five-year energy efficiency program. It allows the Company's Indiana utilities to recover a majority of the costs of promoting the conservation of natural gas through conservation trackers that work in tandem with a lost margin recovery mechanism. The order was implemented in the North service territory in December 2006, and provides for recovery of 85 percent of the difference between weather normalized revenues actually collected by the Company and the revenues approved in the Company's most recent rate case. Energy efficiency programs began in the South gas territory in December 2006. A similar approach regarding lost margin recovery commenced in the South gas territory on August 1, 2007, as the new base rates went into effect, allowing for recovery of 100 percent of the difference between weather normalized revenues actually collected by the Company and the revenues approved in that rate case. It is expected that after the North filing is acted upon, it will be at 100 percent also. While most expenses associated with these programs are recoverable, in the first program year the Company is required to fund \$1.5 million in program costs without recovery.

#### *Ohio*

In June 2007, the Public Utilities Commission of Ohio (PUCO) approved a settlement that provides for the implementation of a lost margin recovery mechanism and a related conservation program for the Company's Ohio operations. This order confirms the guidance the PUCO previously provided in a September 2006 decision. The conservation program, as outlined in the September 2006 PUCO order and as affirmed in this order, provides for a two year, \$2 million total conservation program to be paid by the Company, as well as a sales reconciliation rider intended to be a recovery mechanism for the difference between the weather normalized revenues actually collected by the Company and the revenues approved by the PUCO in the Company's most recent rate case. Approximately 60 percent of the Company's Ohio customers are eligible for the conservation programs. The Ohio Consumer Counselor (OCC) and another intervener requested a rehearing of the June 2007 order and the PUCO granted that request in order to have additional time to consider the merits of the request. In accordance with accounting authorization previously provided by the PUCO, the Company began recognizing the impact of the September 2006 order on October 1, 2006, and has recognized cumulative revenues of \$2.6 million, of which \$1.3 million has been recorded in 2007. The OCC appealed the PUCO's accounting authorization to the Ohio Supreme Court, but that appeal has been dismissed as premature pending the PUCO's consideration of issues raised in the OCC's request for rehearing. Since October 1, 2006, the Company has been ratably accruing its \$2 million commitment.

### MISO

Since February 2002 and with the IURC's approval, the Company has been a member of the Midwest Independent System Operator, Inc. (MISO), a FERC approved regional transmission organization. The MISO serves the electrical transmission needs of much of the Midwest and maintains operational control over the Company's electric transmission facilities as well as that of other Midwest utilities.

On April 1, 2005, the MISO energy market commenced operation (the Day 2 energy market). As a result of being a market participant, the Company now bids its owned generation into the Day Ahead and Real Time markets and procures power for its retail customers at Locational Marginal Pricing (LMP) as determined by the MISO market. The Company is typically in a net sales position with MISO and is only occasionally in a net purchase position. Net positions are determined on an hourly basis. When the Company is a net seller such net revenues are included in *Electric Utility Revenues* and when the Company is a net purchaser such net purchases are included in *Cost of Fuel and Purchased Power*. The Company also receives transmission revenue that results from another members' use of the Company's transmission system. These revenues are also included in *Electric Utility Revenues*.

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Pursuant to an order from the IURC received in December 2001, certain MISO startup costs (referred to as Day 1 costs) were deferred, and those deferred costs are now being recovered through base rates that went into effect on August 15, 2007. On June 1, 2005, Vectren, together with three other Indiana electric utilities, received regulatory authority from the IURC to recover fuel related costs and to defer other costs associated with the Day 2 energy market. The order allows fuel related costs to be passed through to customers in Vectren's existing fuel cost recovery proceedings. During 2006, the IURC reaffirmed the definition of certain costs as fuel related; the Company is following those guidelines. Other MISO fuel related and non-fuel related costs were deferred, and those deferred costs are now being recovered through base rates that went into effect on August 15, 2007. The IURC order authorizing new base rates also provides for a tracking mechanism associated with ongoing MISO-related costs and transmission revenues.

As a result of MISO's operational control over much of the Midwestern electric transmission grid, including SIGECO's transmission facilities, SIGECO's continued ability to import power, when necessary, and export power to the wholesale market has been, and may continue to be, impacted. Given the nature of MISO's policies regarding use of transmission facilities, as well as ongoing FERC initiatives, uncertainties around Day 2 energy market operations and a pending Day 3 market, where MISO plans to provide bid-based-regulation and contingency operating reserve markets, it is difficult to predict near term operational impacts. However, as stated above, it is believed that MISO's regional operation of the transmission system will ultimately lead to reliability improvements. MISO has indicated that the Day 3 ancillary services market would begin in June 2008.

The potential need to expend capital for improvements to the transmission system, both to SIGECO's facilities as well as to those facilities of adjacent utilities, over the next several years will become more predictable as MISO completes studies related to regional transmission planning and improvements. Such expenditures may be significant. The Company will timely recover its investment in certain new electric transmission projects that benefit the MISO infrastructure outside of the Company's service territory at a FERC approved rate of return.

### Gas Cost Recovery (GCR) Audit Proceedings

In 2005, the PUCO issued an order disallowing the recovery of approximately \$9.6 million of gas costs relating to the two-year audit period ended October 2002 and in 2006, an additional \$0.8 million was disallowed related to the audit period ending October 2005. The initial audit period provided the PUCO staff its initial review of the portfolio administration arrangement between VEDO and ProLiance. Since November 1, 2005, the Company has used a provider other than ProLiance for these services.

Through a series of rehearings and appeals, including action by the Ohio Supreme Court in the first quarter of 2007, the Company was required to refund \$8.6 million to customers. The Company had previously recorded the impact of the PUCO findings, including its estimate of the share of the ultimate disallowance to be received from its partner in ProLiance.

### Integrated Gasification Combined Cycle Project Involvement

In August 2007, the Company announced that it has determined to not participate in the proposed Edwardsport, Indiana, Integrated Gasification Combined Cycle (IGCC) generating plant with Duke Energy Indiana, Inc. (Duke). Based upon a review and analysis of the Company's expected electric generation requirements, the expected demand for energy on the system may be more appropriately satisfied through the use of other alternatives, including additional natural gas peaking generation, purchased power, renewable resources and increased customer conservation. The Company has paid Duke approximately \$3.0 million for engineering studies and related costs. By separate agreement with Duke, the Company expects to be reimbursed for all costs and expenses it has paid to Duke.

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**13. Adoption of FIN 48**

The Company and/or certain of its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. The Internal Revenue Service (IRS) has conducted its examination of the Company's U.S. federal income tax returns for tax years through December 31, 2004. The State of Indiana, the Company's primary state tax jurisdiction, has conducted examinations of state income tax returns for tax years through December 31, 2002. No examinations are currently ongoing.

On January 1, 2007, the Company adopted FASB Interpretation No. 48 (FIN 48) "Accounting for Uncertainty in Income Taxes" an interpretation of SFAS 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of tax positions taken or expected to be taken in an income tax return. FIN 48 also provides guidance related to reversal of tax positions, balance sheet classification, interest and penalties, interim period accounting, disclosure and transition.

As a result of the implementation of FIN 48, the Company recognized an approximate \$0.3 million increase in the liability for unrecognized tax benefits, of which \$0.1 million was accounted for as a reduction to the January 1, 2007, balance of *Retained earnings* and \$0.2 million was recorded as an increase to *Goodwill*. At adoption, the total amount of gross unrecognized tax benefits for uncertain tax positions, including positions impacting only the timing of tax benefits, was \$11.6 million. During the nine months ended September 30, 2007, the Company settled approximately \$1.4 million of that obligation. At September 30, 2007, the liability for uncertain positions totaled \$8.9 million. The remaining decrease results from changes in estimates that charge against deferred taxes.

The amount of unrecognized tax benefits, which, if recognized, that would impact the effective tax rate as of September 30, 2007, was \$1.2 million. The remaining unrecognized tax benefit relates to tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

From time to time, the Company may consider changes to filed positions that could decrease the liability for uncertain tax positions. However, it is not expected that such changes would have a significant impact on earnings and would only affect the timing of payments to taxing authorities.

The Company accrues interest and penalties associated with unrecognized tax benefits in *Income taxes*. During the nine months ended September 30, 2007 and September 30, 2006, the Company recognized expense related to interest and penalties totaling approximately \$0.6 million and \$0.1 million, respectively. The Company had approximately \$0.9 million and \$1.0 million for the payment of interest and penalties accrued as of September 30, 2007 and December 31, 2006, respectively.

**14. Segment Reporting**

The Company segregates its operations into three groups: 1) Utility Group, 2) Nonutility Group, and 3) Corporate and Other.

The Utility Group is comprised of Vectren Utility Holdings, Inc.'s operations, which consist of the Company's regulated operations and other operations that provide information technology and other support services to those regulated operations. The Company segregates its regulated operations into a Gas Utility Services operating segment and an Electric Utility Services operating segment. The Gas Utility Services segment provides natural gas distribution and transportation services to nearly two-thirds of Indiana and to west central Ohio. The Electric Utility Services



segment provides electric distribution services primarily to southwestern Indiana, and includes the Company's power generating and wholesale marketing operations. The Company manages its regulated operations as separated between Energy Delivery, which includes the gas and electric transmission and distribution functions, and Power Supply, which includes the power generating and marketing operations. In total, regulated operations supply natural gas and /or electricity to over one million customers. In total, the Utility Group has three operating segments as defined by SFAS 131 "Disclosure About Segments of an Enterprise and Related Information" (SFAS 131).

The Nonutility Group is comprised of one operating segment as defined by SFAS 131 that includes various subsidiaries and affiliates investing in energy marketing and services, coal mining, and energy infrastructure services, among other energy-related opportunities.

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Corporate and Other includes unallocated corporate expenses such as advertising and charitable contributions, among other activities, that benefit the Company's other operating segments. Net income is the measure of profitability used by management for all operations. Information related to the Company's business segments is summarized below:

<i>(In millions)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
<b>Revenues</b>				
Utility Group				
Gas Utility Services	\$ 114.0	\$ 116.8	\$ 890.0	\$ 848.6
Electric Utility Services	143.6	123.2	361.6	324.4
Other Operations	10.1	9.2	30.3	27.5
Eliminations	(9.7)	(8.7)	(29.0)	(26.1)
Total Utility Group	258.0	240.5	1,252.9	1,174.4
Nonutility Group	154.7	128.9	473.5	350.8
Eliminations	(31.3)	(28.9)	(89.3)	(92.7)
Consolidated Revenues	\$ 381.4	\$ 340.5	\$ 1,637.1	\$ 1,432.5
<b>Profitability Measure - Net Income (Loss)</b>				
Utility Group Net Income (Loss)				
Gas Utility Services	\$ (8.5)	\$ (10.3)	\$ 26.0	\$ 18.7
Electric Utility Services	18.6	14.2	39.6	33.6
Other Operations	0.6	2.6	4.0	4.7
Utility Group Net Income	10.7	6.5	69.6	57.0
Nonutility Group Net Income	6.6	5.5	33.4	16.9
Corporate & Other Net Income (Loss)	(0.2)	-	0.2	-
Consolidated Net Income	\$ 17.1	\$ 12.0	\$ 103.2	\$ 73.9

**15. Impact of Recently Issued Accounting Guidance**SFAS No. 157

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; however, the standard will impact how other fair value based GAAP is applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company will adopt SFAS 157 on January 1, 2008, and is currently assessing the impact this statement will have on its financial statements and results of operations.

SFAS 159

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value. Items eligible for the fair value measurement option include: financial assets and financial liabilities with certain exceptions; firm commitments that would otherwise not be recognized at inception and that involve only financial instruments; nonfinancial insurance contracts and warranties that the insurer can settle by paying a third party to provide those goods or services; and host financial instruments resulting from separation of an embedded financial derivative instrument from a nonfinancial hybrid instrument. The fair value option may be applied instrument by instrument, with few exceptions, is an irrevocable election and is applied only to entire instruments. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company will adopt SFAS 159 on January 1, 2008, and is currently assessing the

impact this statement will have on its financial statements and results of operations.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Description of the Business**

Vectren Corporation (the Company or Vectren), an Indiana corporation, is an energy holding company headquartered in Evansville, Indiana. The Company's wholly owned subsidiary, Vectren Utility Holdings, Inc. (Utility Holdings), serves as the intermediate holding company for three operating public utilities: Indiana Gas Company, Inc. (Indiana Gas), Southern Indiana Gas and Electric Company (SIGECO), and the Ohio operations. Utility Holdings also has other assets that provide information technology and other services to the three utilities. Utility Holdings' consolidated operations are collectively referred to as the Utility Group. Vectren and Utility Holdings are holding companies as defined by the Energy Policy Act of 2005.

Indiana Gas provides energy delivery services to approximately 565,000 natural gas customers located in central and southern Indiana. SIGECO provides energy delivery services to approximately 141,000 electric customers and approximately 112,000 gas customers located near Evansville in southwestern Indiana. SIGECO also owns and operates electric generation to serve its electric customers and optimizes those assets in the wholesale power market. Indiana Gas and SIGECO generally do business as Vectren Energy Delivery of Indiana. The Ohio operations provide energy delivery services to approximately 318,000 natural gas customers located near Dayton in west central Ohio. The Ohio operations are owned as a tenancy in common by Vectren Energy Delivery of Ohio, Inc. (VEDO), a wholly owned subsidiary, (53% ownership) and Indiana Gas (47% ownership). The Ohio operations generally do business as Vectren Energy Delivery of Ohio.

The Company, through Vectren Enterprises, Inc. (Enterprises), is also involved in nonutility activities in three primary business areas: Energy Marketing and Services, Coal Mining and Energy Infrastructure Services. Energy Marketing and Services markets and supplies natural gas and provides energy management services. Coal Mining mines and sells coal. Energy Infrastructure Services provides underground construction and repair and energy performance contracting services. Enterprises also has other businesses that invest in energy-related opportunities and services, real estate, and leveraged leases, among other investments. In addition, the Company has investments that generate synfuel tax credits and processing fees relating to the production of coal-based synthetic fuels. These operations are collectively referred to as the Nonutility Group. Enterprises supports the Company's regulated utilities pursuant to service contracts by providing natural gas supply services, coal, infrastructure services, and other services.

The Utility Group generates revenue primarily from the delivery of natural gas and electric service to its customers. The primary source of cash flow for the Utility Group results from the collection of customer bills and the payment for goods and services procured for the delivery of gas and electric services. The activities of and revenues and cash flows generated by the Nonutility Group are closely linked to the utility industry, and the results of those operations are generally impacted by factors similar to those impacting the overall utility industry. However, managing each group requires distinct competencies and business strategies since they offer different energy and energy related products and services and experience different opportunities and risks. The Company therefore analyzes the contribution to consolidated earnings of the Utility Group and Nonutility Group separately. In addition, there are other operations referred to herein as Corporate and Other that include unallocated corporate expenses such as advertising and charitable contributions, among other activities, that benefit the Utility and Nonutility Groups.

In this discussion and analysis of results of operations, the results of the Utility Group, Nonutility Group, and Corporate and Other are presented on a per share basis. Such per share amounts are based on the earnings contribution of each group included in Vectren's consolidated results divided by Vectren's basic average shares outstanding during the period. The earnings per share of the groups do not represent a direct legal interest in the assets and liabilities allocated to the groups, but rather represent a direct equity interest in Vectren Corporation's assets

and liabilities as a whole.

The Company has in place a disclosure committee that consists of senior management as well as financial management. The committee is actively involved in the preparation and review of the Company's SEC filings.

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Table of Contents**Executive Summary of Consolidated Results of Operations**

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto.

<i>(In millions, except per share data)</i>	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2007	2006	2007	2006
Net income	\$ 17.1	\$ 12.0	\$ 103.2	\$ 73.9
Attributed to:				
Utility Group	\$ 10.7	\$ 6.5	\$ 69.6	\$ 57.0
Nonutility Group	6.6	5.5	33.4	16.9
Corporate & Other	(0.2)	-	0.2	-
Basic earnings per share	\$ 0.23	\$ 0.16	\$ 1.36	\$ 0.98
Attributed to:				
Utility Group	\$ 0.14	\$ 0.09	\$ 0.92	\$ 0.75
Nonutility Group	0.09	0.07	0.44	0.23
Corporate & Other	-	-	-	-

**Results**

For the three months ended September 30, 2007, net income was \$17.1 million, or \$0.23 per share, compared to \$12.0 million, or \$0.16 per share, for the three months ended September 30, 2006. For the nine months ended September 30, 2007, net income was \$103.2 million, or \$1.36 per share, compared to \$73.9 million, or \$0.98 per share, for the nine months ended September 30, 2006. The increases in 2007 results are primarily attributable to higher gas and electric utility margins, including the favorable impact of cooling weather, increased customer usage including lost margin recovery, new gas and electric base rates, and increased synfuel-related results. Year to date results also reflect increased earnings from the Company's three primary nonutility operations.

The Utility Group's 2007 earnings for the quarter ended September 30, 2007 were \$10.7 million compared to \$6.5 million in 2006 and \$69.6 million for the nine months ended September 30, 2007 compared to \$57.0 million in 2006. The increases in Utility Group earnings resulted from base rate increases in the Vectren South service territory; the combined impact of increased residential and commercial usage and lost margin recovery; and favorable weather. The increase was offset somewhat by increased operating costs including depreciation expense and a lower effective tax rate in 2006.

In the Company's electric and Ohio natural gas service territories that are not protected by weather normalization mechanisms, management estimates the margin impact of weather experienced during the third quarter of 2007 to be \$4.8 million favorable compared to normal and \$5.5 million favorable compared to the prior year. Year to date, management estimates the margin impact of weather experienced during 2007 to be \$5.4 million favorable compared to normal and \$12.1 million favorable compared to the prior year.

The Nonutility Group's third quarter 2007 earnings, inclusive of primary operations and synfuel related results, were \$6.6 million compared to \$5.5 million in 2006 and \$33.4 million for the nine months ended September 30, 2007, compared to \$16.9 million in 2006. The Company's primary nonutility operations contributed earnings of \$3.0 million in the three months ended September 30, 2007, as compared to \$5.0 million in 2006. Year to date earnings from these primary nonutility operations were \$24.9 million, an increase of \$4.4 million compared to 2006. Primary nonutility operations are Energy Marketing and Services companies, Coal Mining operations, and Energy Infrastructure Services

companies.

Year to date earnings from ProLiance Energy, LLC (ProLiance) increased \$2.7 million due in part to increased storage capacity and greater optimization opportunities. The year to date increase in earnings from Miller Pipeline (Miller) approximates \$3.4 million. The increase is primarily due to Vectren's 100 percent ownership of Miller in 2007 and more large gas construction projects. The year to date increased earnings from Miller and ProLiance are partially offset by lower Coal Mining results. In the current quarter, earnings from primary nonutility operations declined compared to the prior year. Increased earnings from Miller in the quarter were more than offset by lower results from ProLiance and Coal Mining.

Synfuel-related results included in net income for the quarter were earnings of \$3.5 million, or \$0.05 per share, in 2007, compared to \$0.6 million, or \$0.01 per share, in 2006. Year to date in 2007, Synfuel-related results included in net income were earnings of \$8.3 million, or \$0.11 per share, compared to a loss of \$3.7 million, or \$0.05 per share, in 2006. In 2006, Synfuel-related activity includes a second quarter \$5.7 million after tax impairment charge related to the Company's investment in Pace Carbon Synfuels LP. Quarterly results in 2007 include a \$4.9 million after tax mark-to-market gain on financial contracts related to 2007 production, and a \$4.1 million after tax mark-to-market gain year to date.

### **Dividends**

Dividends declared for the three months ended September 30, 2007, were \$0.315 per share compared to \$0.305 per share for the same period in 2006. Dividends declared for the nine months ended September 30, 2007, were \$0.945 per share compared to \$0.915 per share for the same period in 2006.

In October 2007, the Board of Directors approved an increase of 1 cent to the regular quarterly common stock dividend from the prior quarter to 32 ½ cents per share. The increase marks the 48<sup>th</sup> consecutive year Vectren and predecessor companies' have increased annual dividends paid.

### **Detailed Discussion of Results of Operations**

Following is a more detailed discussion of the results of operations of the Utility Group and Nonutility Group. The detailed results of operations for these operations are presented and analyzed before the reclassification and elimination of certain intersegment transactions necessary to consolidate those results into the Company's Consolidated Condensed Statements of Income. Corporate and Other operations are not significant.



Table of Contents**Results of Operations of the Utility Group**

The Utility Group is comprised of Utility Holdings' operations. The operations of the Utility Group consist of the Company's regulated operations and other operations that provide information technology and other support services to those regulated operations. The Company segregates its regulated operations into a Gas Utility Services operating segment and an Electric Utility Services operating segment. The Gas Utility Services segment includes the operations of Indiana Gas, the Ohio operations, and SIGECO's natural gas distribution business and provides natural gas distribution and transportation services to nearly two-thirds of Indiana and to west central Ohio. The Electric Utility Services segment includes the operations of SIGECO's electric transmission and distribution services, which provides electric distribution services primarily to southwestern Indiana, and the Company's power generating and asset optimization operations. In total, these regulated operations supply natural gas and/or electricity to over one million customers. The Utility Group's other operations are not significant. Utility operating results before certain intersegment eliminations and reclassifications for the three and nine months ended September 30, 2007 and 2006 follow:

<i>(In millions, except per share amounts)</i>	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>OPERATING REVENUES</b>				
Gas utility revenues	\$ 114.0	\$ 116.8	\$ 890.0	\$ 848.6
Electric utility revenues	143.6	123.2	361.6	324.4
Other revenues	0.4	0.5	1.3	1.4
<b>Total operating revenues</b>	<b>258.0</b>	<b>240.5</b>	<b>1,252.9</b>	<b>1,174.4</b>
<b>OPERATING EXPENSES</b>				
Cost of gas sold	52.9	59.9	592.0	577.4
Cost of fuel & purchased power	50.5	46.8	129.5	115.8
Other operating	65.6	61.6	198.4	182.8
Depreciation & amortization	40.4	38.0	119.4	112.8
Taxes other than income taxes	11.3	10.5	49.6	44.9
Total operating expenses	220.7	216.8	1,088.9	1,033.7
<b>OPERATING INCOME</b>	<b>37.3</b>	<b>23.7</b>	<b>164.0</b>	<b>140.7</b>
Other income - net	1.3	2.0	6.2	4.8
Interest expense	20.8	19.2	58.8	57.4
<b>INCOME BEFORE INCOME TAXES</b>	<b>17.8</b>	<b>6.5</b>	<b>111.4</b>	<b>88.1</b>
Income taxes	7.1	-	41.8	31.1
<b>NET INCOME</b>	<b>\$ 10.7</b>	<b>\$ 6.5</b>	<b>\$ 69.6</b>	<b>\$ 57.0</b>
<b>CONTRIBUTION TO VECTREN BASIC EPS</b>	<b>\$ 0.14</b>	<b>\$ 0.09</b>	<b>\$ 0.92</b>	<b>\$ 0.75</b>

**Significant Fluctuations**Utility Group Margin

Throughout this discussion, the terms Gas Utility margin and Electric Utility margin are used. Gas Utility margin is calculated as *Gas utility revenues* less the *Cost of gas*. Electric Utility margin is calculated as *Electric utility revenues* less *Cost of fuel & purchased power*. These measures exclude *Other operating expenses*, *Depreciation and amortization*, and *Taxes other than income taxes*, which are included in the calculation of operating income. The Company believes Gas Utility and Electric Utility margins are better indicators of relative contribution than revenues since gas prices and fuel costs can be volatile and are generally collected on a dollar-for-dollar basis from customers.

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Sales of natural gas and electricity to residential and commercial customers are seasonal and are impacted by weather. Trends in average use among natural gas residential and commercial customers have tended to decline in recent years as more efficient appliances and furnaces are installed and the price of natural gas has increased. Normal temperature adjustment (NTA) and lost margin recovery mechanisms largely mitigate the effect on Gas Utility margin that would otherwise be caused by variations in volumes sold due to weather and changing consumption patterns. Indiana Gas' territory has both an NTA since 2005 and lost margin recovery since December 2006. SIGECO's natural gas territory has an NTA since 2005, and lost margin recovery began when new base rates went into effect August 1, 2007. The Ohio service territory has lost margin recovery since October 2006, but does not have an NTA mechanism. Electric use among residential and commercial classes has remained relatively stable. SIGECO's electric service territory does not have an NTA mechanism and its tariffs generally do not provide for lost margin recovery.

Gas and electric margin generated from sales to large customers (generally industrial and other contract customers) is primarily impacted by overall economic conditions. Margin is also impacted by the collection of state mandated taxes, which fluctuate with gas and fuel costs, as well as other tracked expenses. Expenses subject to tracking mechanisms include Ohio bad debts and percent of income payment plan expenses, Indiana gas pipeline integrity management costs, and costs to fund Indiana energy efficiency programs. Certain operating costs associated with operating environmental compliance equipment were also tracked prior to their recovery in base rates that went into effect on August 15, 2007. The August SIGECO rate orders also provide for the tracking of MISO revenues and costs, as well as the gas cost component of bad debt expense and unaccounted for gas. Electric generating asset optimization activities are primarily affected by market conditions, the level of excess generating capacity, and electric transmission availability. Following is a discussion and analysis of margin generated from regulated utility operations.

*Gas Utility Margin (Gas Utility revenues less Cost of gas sold)*

Gas Utility margin and throughput by customer type follows:

<i>(In millions)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
Gas utility revenues	\$ 114.0	\$ 116.8	\$ 890.0	\$ 848.6
Cost of gas sold	52.9	59.9	592.0	577.4
<b>Total gas utility margin</b>	<b>\$ 61.1</b>	<b>\$ 56.9</b>	<b>\$ 298.0</b>	<b>\$ 271.2</b>
Margin attributed to:				
Residential & Commercial	\$ 45.9	\$ 44.8	\$ 249.8	\$ 226.5
Industrial	9.2	9.5	34.9	34.2
Other	6.0	2.6	13.3	10.5
Sold & transported volumes in MMDth attributed to:				
To residential & commercial customers	6.4	7.0	75.1	63.7
To industrial customers	18.0	17.7	62.5	61.2
<b>Total throughput</b>	<b>24.4</b>	<b>24.7</b>	<b>137.6</b>	<b>124.9</b>

For the three and nine months ended September 30, 2007, Gas Utility margins were \$61.1 million and \$298.0 million, respectively, an increase of \$4.2 million quarter over quarter and \$26.8 million year over year. Residential and commercial customer usage, including lost margin recovery, increased margin \$1.2 million during the quarter and \$12.7 million year over year. Year to date, Ohio weather was 4 percent warmer than normal, but 10 percent colder than the prior year and resulted in an estimated increase in margin of approximately \$2.0 million compared to 2006. Margin increases associated with the Vectren South base rate increase, effective August 1, 2007, were \$0.7 million. Recovery of gas storage carrying costs in Ohio was \$1.3 million quarter over quarter and \$1.6 million year to date. Lastly, costs recovered dollar-for-dollar in margin associated with tracked expenses and revenue and usage taxes increased gas margin \$0.4 million in the quarter and \$8.3 million year over year. The average cost per dekatherm of

gas purchased for the nine months ended September 30, 2007, was \$8.13 compared to \$8.89 in 2006.

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Table of Contents*Electric Utility Margin (Electric Utility revenues less Cost of fuel & purchased power)*

Electric Utility margin by customer type follows:

<i>(In millions)</i>	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2007	2006	2007	2006
Electric utility revenues	\$ 143.6	\$ 123.2	\$ 361.6	\$ 324.4
Cost of fuel & purchased power	50.5	46.8	129.5	115.8
<b>Total electric utility margin</b>	<b>\$ 93.1</b>	<b>\$ 76.4</b>	<b>\$ 232.1</b>	<b>\$ 208.6</b>
Residential & commercial	\$ 64.5	\$ 49.3	\$ 147.9	\$ 125.6
Industrial	21.6	18.9	56.4	53.4
Municipalities & other	4.4	6.6	14.7	18.9
<b>Subtotal: retail &amp; firm wholesale</b>	<b>\$ 90.5</b>	<b>\$ 74.8</b>	<b>\$ 219.0</b>	<b>\$ 197.9</b>
Asset optimization	\$ 2.6	\$ 1.6	\$ 13.1	\$ 10.7

## Electric volumes sold in GWh attributed to:

Residential & commercial customers	954.4	847.0	2,357.7	2,152.4
Industrial customers	638.7	674.7	1,942.4	1,983.9
Municipalities & other	192.1	182.9	483.5	494.7
<b>Total retail &amp; firm wholesale volumes sold</b>	<b>1,785.2</b>	<b>1,704.6</b>	<b>4,783.6</b>	<b>4,631.0</b>

*Retail & Firm Wholesale Margin*

Electric retail and firm wholesale utility margins were \$90.5 million and \$219.0 million for the three and nine months ended September 30, 2007. These represent increases over the prior year periods of \$15.7 million and \$21.1 million, respectively. Management estimates the period over period increases in usage by residential and commercial customers due to weather to be \$5.9 million in the quarter and \$10.1 million year to date. The base rate increase that went into effect on August 15, 2007, produced incremental margin of \$6.4 million, and recovery of pollution control investments and expenses increased margin \$1.3 million in the quarter and \$3.2 million year over year. Impacts of weather on volumes sold were offset in the quarter by a large industrial customer's planned outage.

*Margin from Asset Optimization Activities*

Periodically, generation capacity is in excess of that needed to serve native load and firm wholesale customers. The Company markets and sells this unutilized generating and transmission capacity to optimize the return on its owned assets. On an annual basis, a majority of the margin generated from these activities is associated with wholesale off-system sales, and substantially all off-system sales occur into the MISO day-ahead market.

Following is a reconciliation of asset optimization activity:

<i>(In millions)</i>	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2007	2006	2007	2006
Off-system sales	\$ 1.1	\$ 1.2	\$ 9.9	\$ 11.9
Transmission system sales	1.5	1.0	3.2	2.5
Other	-	(0.6)	-	(3.7)
<b>Total asset optimization</b>	<b>\$ 2.6</b>	<b>\$ 1.6</b>	<b>\$ 13.1</b>	<b>\$ 10.7</b>

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For the three and nine months ended September 30, 2007, net asset optimization margins were \$2.6 million and \$13.1 million, which represents increases of \$1.0 million and \$2.4 million, compared to 2006. The increases are primarily due to losses on financial contracts experienced in 2006 offset partially by lower availability of generating units for off system sales in 2007, due largely to the retirement of 50 MW of owned generation on December 31, 2006. Year to date off-system sales totaled 571.7 GWh in 2007, compared to 755.0 GWh in 2006.

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### Other Operating Expenses

For the three and nine months ended September 30, 2007, *Other operating expenses* were \$65.6 million and \$198.4 million, which represent increases of \$4.0 million and \$15.6 million, compared to 2006. Pass-through costs, including costs funding new Indiana energy efficiency programs that are recovered in utility margin, increased \$0.6 million in the quarter and \$7.3 million year over year. Increases in operating costs associated with lost margin recovery and conservation initiatives that are not directly recovered in margin were \$0.3 million in the quarter and \$1.3 million year over year. Third quarter planned outage costs associated with a jointly owned turbine resulted in \$2.5 million of increased costs. The remaining increases are primarily due to increased wage and benefit costs, other operating cost increases, and timing of expenses.

### Depreciation & Amortization

For the three and nine months ended September 30, 2007, *Depreciation and amortization* expenses were \$40.4 million and \$119.4 million, which represents increases of \$2.4 million and \$6.6 million compared to 2006. The increases were primarily due to increased utility plant and also include \$0.5 million of amortization associated with electric demand side management costs permitted to be recovered pursuant to the August 15<sup>th</sup> electric base rate order.

### Taxes Other Than Income Taxes

For the three and nine months ended September 30, 2007, *Taxes other than income taxes* were \$11.3 million and \$49.6 million, which represent increases of \$0.8 million and \$4.7 million compared to 2006. The year to date increase results primarily from increased property taxes and higher revenues subject to taxes.

### Other Income-Net

*Other-net* reflects income of \$1.3 million for the quarter and \$6.2 million year to date. The \$0.7 million decrease in the quarter and \$1.4 million increase year to date are primarily related to the capitalization of funds used during construction.

### Interest Expense

For the three and nine months ended September 30, 2007, *Interest expense* was \$20.8 million and \$58.8 million, which represents increases of \$1.6 million and \$1.4 million compared to 2006. The increases reflect higher interest rates associated with short-term borrowings and are partially offset by the impact of financing transactions completed in October 2006, in which about \$93 million in debt-related proceeds were raised and used to retire higher interest rate debt.

### Income Taxes

Federal and state *income taxes* were \$7.1 million for the quarter and \$41.8 million year to date, increases of \$7.1 million and \$10.7 million compared to the prior year periods. The higher taxes are primarily due to higher pretax income and a lower effective tax rate in 2006. The lower effective tax rate in 2006 primarily relates to favorable adjustments approximating \$2.0 million recorded in the third quarter of 2006 reflective of final taxes reported on 2005 state and federal income tax returns and a \$1.5 million favorable impact for an Indiana tax law change that resulted in the recalculation of certain state deferred income tax liabilities.

## Environmental Matters

### Clean Air/Climate Change

In March of 2005 USEPA finalized two new air emission reduction regulations. The Clean Air Interstate Rule (CAIR) is an allowance cap and trade program requiring further reductions in Nitrogen Oxides (NO<sub>x</sub>) and Sulfur Dioxide (SO<sub>2</sub>) emissions from coal-burning power plants. The Clean Air Mercury Rule (CAMR) is an allowance cap and trade program requiring further reductions in mercury emissions from coal-burning power plants. Both sets of regulations require emission reductions in two phases. The first phase deadline for both rules is 2010 (2009 for NO<sub>x</sub> under CAIR), and the second phase deadline for compliance with the emission reductions required under CAIR is 2015, while the second phase deadline for compliance with the emission reduction requirements of CAMR is 2018. The Company is evaluating compliance options and fully expects to be in compliance by the required deadlines.

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In February 2006, the IURC approved a multi-emission compliance plan filed by the Company's utility subsidiary, SIGECO. Once the plan is implemented, SIGECO's coal-fired plants will be 100% scrubbed for SO<sub>2</sub>, 90% scrubbed for NO<sub>x</sub>, and mercury emissions will be reduced to meet the new mercury reduction standards. The order, as previously agreed to by the OUCC and Citizens Action Coalition, allows SIGECO to recover an approximate 8% return on up to \$110 million in capital investments through a rider mechanism which is updated every six months for actual costs incurred. The Company may file periodic updates with the IURC requesting modification to the spending authority. The Company will also recover through a rider its operating expenses, including depreciation, once the equipment is placed into service. As of September 30, 2007, the Company has made capital investments of approximately \$91 million related to this environmental requirement. Of that amount, \$49.4 million was placed into service on January 1, 2007 and was included in rate base for purposes of determining new base rates that went into effect on August 15, 2007 (See Rate and Regulatory Matter Section).

If legislation requiring reductions in carbon dioxide and other greenhouse gases is adopted, such regulation could substantially affect both the costs and operating characteristics of the Company's fossil fuel generating plants and nonutility coal mining operations. At this time and in absence of final legislation, compliance costs and other effects associated with reductions in greenhouse gas emissions remain uncertain.

Pursuant to an IURC order, SIGECO is studying renewable energy alternatives, and on April 9, 2007, filed a green power rider in order to allow customers to purchase green power and is also seeking approval of a contract to purchase 30 MW of power generated by wind energy. Future filings with the IURC with regard to new generation and/or further environmental compliance plans will include evaluation of potential carbon requirements.

### Environmental Remediation Efforts

In the past, Indiana Gas, SIGECO, and others operated facilities for the manufacture of gas. Given the availability of natural gas transported by pipelines, these facilities have not been operated for many years. Under currently applicable environmental laws and regulations, those that operated these facilities may now be required to take remedial action if certain contaminants are found above the regulatory thresholds at these sites.

Indiana Gas identified the existence, location, and certain general characteristics of 26 gas manufacturing and storage sites for which it may have some remedial responsibility. Indiana Gas completed a remedial investigation/feasibility study (RI/FS) at one of the sites under an agreed order between Indiana Gas and the IDEM, and a Record of Decision was issued by the IDEM in January 2000. Although Indiana Gas has not begun an RI/FS at additional sites, Indiana Gas has submitted several of the sites to the IDEM's Voluntary Remediation Program (VRP) and is currently conducting some level of remedial activities, including groundwater monitoring at certain sites, where deemed appropriate, and will continue remedial activities at the sites as appropriate and necessary.

Indiana Gas accrued the estimated costs for further investigation, remediation, groundwater monitoring, and related costs for the sites. While the total costs that may be incurred in connection with addressing these sites cannot be determined at this time, Indiana Gas has recorded costs that it reasonably expects to incur totaling approximately \$20.4 million.

The estimated accrued costs are limited to Indiana Gas' share of the remediation efforts. Indiana Gas has arrangements in place for 19 of the 26 sites with other potentially responsible parties (PRP), which serve to limit Indiana Gas' share of response costs at these 19 sites to between 20% and 50%. With respect to insurance coverage, Indiana Gas has received and recorded settlements from all known insurance carriers under insurance policies in effect when these plants were in operation in an aggregate amount approximating \$20.4 million.

In October 2002, SIGECO received a formal information request letter from the IDEM regarding five manufactured gas plants that it owned and/or operated and were not enrolled in the IDEM's VRP. In October 2003, SIGECO filed

applications to enter four of the manufactured gas plant sites in IDEM's VRP. The remaining site is currently being addressed in the VRP by another Indiana utility. SIGECO added those four sites into the renewal of the global Voluntary Remediation Agreement that Indiana Gas has in place with IDEM for its manufactured gas plant sites. That renewal was approved by the IDEM in February 2004. SIGECO is also named in a lawsuit filed in federal district court in May 2007, involving another site subject to potential environmental remediation efforts.

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SIGECO has filed a declaratory judgment action against its insurance carriers seeking a judgment finding its carriers liable under the policies for coverage of further investigation and any necessary remediation costs that SIGECO may accrue under the VRP program and/or related to the site subject to the May 2007 lawsuit. While the total costs that may be incurred in connection with addressing these sites cannot be determined at this time, SIGECO has recorded costs that it reasonably expects to incur totaling approximately \$7.7 million. With respect to insurance coverage, SIGECO has received and recorded settlements from insurance carriers under insurance policies in effect when these sites were in operation in an aggregate amount approximating the costs it expects to incur.

Environmental remediation costs related to Indiana Gas' and SIGECO's manufactured gas plants and other sites have had no material impact on results of operations or financial condition since costs recorded to date approximate PRP and insurance settlement recoveries. While the Company's utilities have recorded all costs which they presently expect to incur in connection with activities at these sites, it is possible that future events may require some level of additional remedial activities which are not presently foreseen and those costs may not be subject to PRP or insurance recovery.

### Rate and Regulatory Matters

#### Vectren South (SIGECO) Electric Base Rate Order Received

On August 15, 2007, the Company received an order from the IURC which approved a settlement agreement with the OUCC and other interveners regarding the proposed changes to the base rates and charges for its electric distribution business in southwestern Indiana. The settlement agreement provides for an approximate \$60.8 million electric rate increase to cover the Company's cost of system growth, maintenance, safety and reliability. The settlement provides for, among other things: recovery of ongoing costs and deferred costs associated with the MISO; operations and maintenance (O&M) expense increases related to managing the aging workforce, including the development of expanded apprenticeship programs and the creation of defined training programs to ensure proper knowledge transfer, safety and system stability; increased O&M expense necessary to maintain and improve system reliability; benefit to customers from the sale of wholesale power by Vectren's sharing evenly with customers any profit earned above or below \$10.5 million of wholesale power margin; recovery of and return on the investment in past demand side management programs to help encourage conservation during peak load periods; timely recovery of the Company's investment in certain new electric transmission projects that benefit the MISO infrastructure outside of the Company's service territory; an overall rate of return of 7.32 percent on rate base of approximately \$1,044 million and an allowed return on equity (ROE) of 10.4 percent. The increase in *Electric Utility margin* as a result of this order totaled \$6.4 million in the three and nine months ended September 30, 2007.

#### Vectren South (SIGECO) Gas Base Rate Order Received

On August 1, 2007, the Company received an order from the IURC which approved, with a minor modification, the settlement agreement previously reached with the Indiana Office of the Utility Consumer Counselor (OUCC) and other interveners regarding its Vectren South gas rate case. The order provided for a base rate increase of \$5.1 million and an ROE of 10.15 percent, with an overall rate of return of 7.20 percent on rate base of approximately \$122 million. The order also includes removal of \$2.6 million of costs from base rates to be recovered through existing tracking mechanisms.

Further, additional expenditures for a multi-year bare steel and cast iron capital replacement program will be afforded certain accounting treatment that mitigates earnings attrition from the investment between rate cases. The accounting treatment allows for the continuation of the accrual for allowance for funds used during construction (AFUDC) and the deferral of depreciation expense after the projects go in service but before they are included in base rates. To qualify for this treatment, the annual expenditures are limited to \$3.0 million and the treatment cannot extend beyond three years on each project.



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With this order, the company now has in place for its South gas territory weather normalization, a conservation and decoupling tariff, tracking of gas cost expense related to bad debts and unaccounted for gas through the existing gas cost adjustment mechanism, and tracking of pipeline integrity expense. The increase in *Gas Utility margin* as a result of this order totaled \$0.7 million in the three and nine months ended September 30, 2007.

### Vectren North (Indiana Gas Company, Inc.) Gas Base Rate Filing

In May 2007, the Company filed a petition with the IURC to adjust its gas base rates and charges in its North service territory. The petition requests an increase of approximately \$41 million in rates to recover the ongoing cost of operating, maintaining and expanding the approximately 12,000-mile distribution and storage system used to serve more than 565,000 natural gas customers. Components of the requested increase include return on additional utility infrastructure investment, costs associated with federally mandated pipeline integrity management, inspection and other reliability programs, and aging workforce. A hearing on the Company's request before the IURC was held in late August 2007 and the final hearing is scheduled for December 2007. The Company expects an order from the IURC in the second quarter of 2008.

### Vectren Energy Delivery of Ohio, Inc. (VEDO) Filing of Pre-Filing Notice

In September 2007, the Company issued a pre-filing notice with the PUCO indicating it plans to request an increase in its base rate charges for VEDO's distribution business in its 17-county service area in west central Ohio. The filing indicates that an increase in base rates of approximately \$29 million is necessary to cover the ongoing cost of operating, maintaining and expanding the approximately 5,200-mile distribution system used to serve 318,000 customers. Components of the requested increase include return on additional utility infrastructure investment, costs associated with federally mandated pipeline integrity management, inspection and other reliability programs, and aging workforce.

In addition, the Company is seeking extension of the decoupling mechanisms currently in place to encourage customer conservation and also is seeking approval of expanded conservation-oriented programs, such as rebate offerings on high-efficiency natural gas appliances for existing and new home construction, to help customers lower their natural gas bills.

### Ohio and Indiana Lost Margin Recovery/Conservation Filings

In 2005, the Company filed conservation programs and conservation adjustment trackers in Indiana and Ohio designed to help customers conserve energy and reduce their annual gas bills. The programs allow the Company to recover costs of promoting the conservation of natural gas through conservation trackers that work in tandem with a lost margin recovery mechanism. These mechanisms are designed to allow the Company to recover the distribution portion of its rates from residential and commercial customers based on the level of customer revenues established in each utility's last general rate case.

#### *Indiana*

In December 2006, the IURC approved a settlement agreement that provides for a five-year energy efficiency program. It allows the Company's Indiana utilities to recover a majority of the costs of promoting the conservation of natural gas through conservation trackers that work in tandem with a lost margin recovery mechanism. The order was implemented in the North service territory in December 2006, and provides for recovery of 85 percent of the difference between weather normalized revenues actually collected by the Company and the revenues approved in the Company's most recent rate case. Energy efficiency programs began in the South gas territory in December 2006. A similar approach regarding lost margin recovery commenced in the South gas territory on August 1, 2007, as the new base rates went into effect, allowing for recovery of 100 percent of the difference between weather normalized

revenues actually collected by the Company and the revenues approved in that rate case. It is expected that after the North filing is acted upon, it will be at 100 percent also. While most expenses associated with these programs are recoverable, in the first program year the Company is required to fund \$1.5 million in program costs without recovery.

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In June 2007, the Public Utilities Commission of Ohio (PUCO) approved a settlement that provides for the implementation of a lost margin recovery mechanism and a related conservation program for the Company's Ohio operations. This order confirms the guidance the PUCO previously provided in a September 2006 decision. The conservation program, as outlined in the September 2006 PUCO order and as affirmed in this order, provides for a two year, \$2 million total conservation program to be paid by the Company, as well as a sales reconciliation rider intended to be a recovery mechanism for the difference between the weather normalized revenues actually collected by the Company and the revenues approved by the PUCO in the Company's most recent rate case. Approximately 60 percent of the Company's Ohio customers are eligible for the conservation programs. The Ohio Consumer Counselor (OCC) and another intervener requested a rehearing of the June 2007 order and the PUCO granted that request in order to have additional time to consider the merits of the request. In accordance with accounting authorization previously provided by the PUCO, the Company began recognizing the impact of the September 2006 order on October 1, 2006, and has recognized cumulative revenues of \$2.6 million, of which \$1.3 million has been recorded in 2007. The OCC appealed the PUCO's accounting authorization to the Ohio Supreme Court, but that appeal has been dismissed as premature pending the PUCO's consideration of issues raised in the OCC's request for rehearing. Since October 1, 2006, the Company has been ratably accruing its \$2 million commitment.

MISO

Since February 2002 and with the IURC's approval, the Company has been a member of the Midwest Independent System Operator, Inc. (MISO), a FERC approved regional transmission organization. The MISO serves the electrical transmission needs of much of the Midwest and maintains operational control over the Company's electric transmission facilities as well as that of other Midwest utilities.

On April 1, 2005, the MISO energy market commenced operation (the Day 2 energy market). As a result of being a market participant, the Company now bids its owned generation into the Day Ahead and Real Time markets and procures power for its retail customers at Locational Marginal Pricing (LMP) as determined by the MISO market. The Company is typically in a net sales position with MISO and is only occasionally in a net purchase position. Net positions are determined on an hourly basis. When the Company is a net seller such net revenues are included in *Electric Utility Revenues* and when the Company is a net purchaser such net purchases are included in *Cost of Fuel and Purchased Power*. The Company also receives transmission revenue that results from another members' use of the Company's transmission system. These revenues are also included in *Electric Utility Revenues*.

Pursuant to an order from the IURC received in December 2001, certain MISO startup costs (referred to as Day 1 costs) were deferred, and those deferred costs are now being recovered through base rates that went into effect on August 15, 2007. On June 1, 2005, Vectren, together with three other Indiana electric utilities, received regulatory authority from the IURC to recover fuel related costs and to defer other costs associated with the Day 2 energy market. The order allows fuel related costs to be passed through to customers in Vectren's existing fuel cost recovery proceedings. During 2006, the IURC reaffirmed the definition of certain costs as fuel related; the Company is following those guidelines. Other MISO fuel related and non-fuel related administrative related costs were deferred, and those deferred costs are now being recovered through base rates that went into effect on August 15, 2007. The IURC order authorizing new base rates also provides for a tracking mechanism associated with ongoing MISO-related costs and transmission revenues.

As a result of MISO's operational control over much of the Midwestern electric transmission grid, including SIGECO's transmission facilities, SIGECO's continued ability to import power, when necessary, and export power to the wholesale market has been, and may continue to be, impacted. Given the nature of MISO's policies regarding use of transmission facilities, as well as ongoing FERC initiatives, uncertainties around Day 2 energy market operations and

a pending Day 3 market, where MISO plans to provide bid-based-regulation and contingency operating reserve markets, it is difficult to predict near term operational impacts. However, as stated above, it is believed that MISO's regional operation of the transmission system will ultimately lead to reliability improvements. MISO has indicated that the Day 3 ancillary services market would begin in June 2008.

The potential need to expend capital for improvements to the transmission system, both to SIGECO's facilities as well as to those facilities of adjacent utilities, over the next several years will become more predictable as MISO completes studies related to regional transmission planning and improvements. Such expenditures may be significant. The Company will timely recover its investment in certain new electric transmission projects that benefit the MISO infrastructure outside of the Company's service territory at a FERC approved rate of return.

#### Gas Cost Recovery (GCR) Audit Proceedings

In 2005, the PUCO issued an order disallowing the recovery of approximately \$9.6 million of gas costs relating to the two-year audit period ended October 2002 and in 2006, an additional \$0.8 million was disallowed related to the audit period ending October 2005. The initial audit period provided the PUCO staff its initial review of the portfolio administration arrangement between VEDO and ProLiance. Since November 1, 2005, the Company has used a provider other than ProLiance for these services.

Through a series of rehearings and appeals, including action by the Ohio Supreme Court in the first quarter of 2007, the Company was required to refund \$8.6 million to customers. The Company had previously recorded the impact of the PUCO findings, including its estimate of the share of the ultimate disallowance to be received from its partner in ProLiance.

#### Integrated Gasification Combined Cycle Project Involvement

In August 2007, the Company announced that it has determined to not participate in the proposed Edwardsport, Indiana, Integrated Gasification Combined Cycle (IGCC) generating plant with Duke Energy Indiana, Inc. (Duke). Based upon a review and analysis of the Company's expected electric generation requirements, the expected demand for energy on the system may be more appropriately satisfied through the use of other alternatives, including additional natural gas peaking generation, purchased power, renewable resources and increased customer conservation. The Company has paid Duke approximately \$3.0 million for engineering studies and related costs. By separate agreement with Duke, the Company expects to be reimbursed for all costs and expenses it has paid to Duke.



**Results of Operations of the Nonutility Group**

The Nonutility Group is comprised of three primary business areas: Energy Marketing and Services, Coal Mining, and Energy Infrastructure Services. Energy Marketing and Services markets and supplies natural gas and provides energy management services. Coal Mining mines and sells coal. Energy Infrastructure Services provides underground construction and repair and energy performance contracting services. Enterprises also has other businesses that invest in energy-related opportunities and services, real estate, and leveraged leases, among other investments. In addition, the Company has investments that generate synfuel tax credits and processing fees relating to the production of coal-based synthetic fuels. The Nonutility Group supports the Company's regulated utilities pursuant to service contracts by providing natural gas supply services, coal, infrastructure services, and other services. Nonutility Group earnings for the three and nine months ended September 30, 2007 and 2006 follow:

<i>(In millions, except per share amounts)</i>	Three Months		Nine Months	
	Ended September 30, 2007	2006	Ended September 30, 2007	2006
<b>NET INCOME</b>	<b>\$ 6.6</b>	<b>\$ 5.5</b>	<b>\$ 33.4</b>	<b>\$ 16.9</b>
<b>CONTRIBUTION TO VECTREN BASIC EPS</b>	<b>\$ 0.09</b>	<b>\$ 0.07</b>	<b>\$ 0.44</b>	<b>\$ 0.23</b>
<b>NET INCOME (LOSS) ATTRIBUTED TO:</b>				
Energy Marketing & Services	\$ (2.0)	\$ (0.2)	\$ 15.6	\$ 13.0
Coal Mining	0.4	1.6	2.7	4.3
Energy Infrastructure	4.6	3.6	6.6	3.2
Other Businesses	0.1	(0.1)	0.2	0.1
Synfuel-related results	3.5	0.6	8.3	(3.7)

**Energy Marketing and Services**

Energy Marketing and Services is comprised of the Company's wholesale and retail gas marketing businesses. For the three months ended September 30, 2007, Energy Marketing and Services, inclusive of holding company costs, had a loss of \$2.0 million compared to a loss of \$0.2 million in 2006. Year to date earnings were \$15.6 million in 2007 compared to \$13.0 million in 2006.

ProLiance Energy LLC (ProLiance), a nonutility energy marketing affiliate of Vectren and Citizens Gas and Coke Utility (Citizens Gas), provides services to a broad range of municipalities, utilities, industrial operations, schools, and healthcare institutions located throughout the Midwest and Southeast United States. ProLiance's customers include Vectren's Indiana utilities and nonutility gas supply operations and Citizens Gas. ProLiance's primary businesses include gas marketing, gas portfolio optimization, and other portfolio and energy management services. Consistent with its ownership percentage, Vectren is allocated 61% of ProLiance's profits and losses; however, governance and voting rights remain at 50% for each member; and therefore the Company accounts for its investment in ProLiance using the equity method of accounting. Vectren received regulatory approval on April 25, 2006, from the IURC for ProLiance to continue to provide natural gas supply services to the Company's Indiana utilities through March 2011.

ProLiance provided the primary earnings contribution, which totaled \$17.6 million year to date in 2007 compared to \$14.9 million in 2006. ProLiance's storage capacity was 39 Bcf at September 30, 2007 compared to 34 Bcf at the end of 2006. Increased storage capacity and greater optimization opportunities were the primary reasons for the increase in earnings. Quarter over quarter, ProLiance's results decreased \$2.6 million due to decreased volatility impacting optimization opportunities.

ProLiance self reported to the Federal Energy Regulatory Commission (FERC or the Commission) in October 2007 possible non-compliance with the Commission's capacity release policies. ProLiance has taken corrective actions to

assure that current and future transactions are compliant. ProLiance is committed to full regulatory compliance and is cooperating fully with the FERC regarding these issues. ProLiance is unable to predict the outcome of any FERC action.

Vectren Retail, LLC (d/b/a Vectren Source), a wholly owned subsidiary, provides natural gas and other related products and services to customers opting for choice among energy providers.

Vectren Source's seasonal third quarter loss totaled \$1.3 million in 2007 compared to a loss of \$1.9 million in 2006. Year to date, Vectren Source results were near break even in both periods primarily due to lower unit margins offset partially by weather insurance proceeds. Vectren Source's customer count at September 30, 2007, was 156,000 customers, as compared to the prior year quarter of 150,000.

### **Coal Mining Operations**

Coal Mining Operations mine and sell coal to the Company's utility operations and to third parties through its wholly owned subsidiary Vectren Fuels, Inc. (Fuels).

Coal Mining operations third quarter earnings were \$0.4 million compared to \$1.6 million in 2006. Year to date, Coal Mining operations earned approximately \$2.7 million compared to \$4.3 million in 2006. The declines are primarily due to the transitional effects of compliance with revised Mine Safety and Health Administration (MSHA) seal guidelines, and the associated lost production, and high sulfur content from the revised mining plan. These decreases are offset somewhat by reduced operating costs from highwall mining at the Cypress Creek surface mine.

### **Energy Infrastructure Services**

Energy Infrastructure Services provides energy performance contracting operations through Energy Systems Group, LLC (ESG) and underground construction and repair to utility infrastructure through Miller Pipeline (Miller). Inclusive of holding company costs, Energy Infrastructure's operations contributed earnings of \$4.6 million in the third quarter of 2007 compared to \$3.6 million in 2006. Year to date earnings were \$6.6 million in 2007 compared to \$3.2 million in 2006.

Miller's 2007 earnings were \$3.7 million in the third quarter, compared to \$1.7 million in 2006. Year to date, Miller earned approximately \$4.8 million in 2007 compared to \$1.4 million in 2006. The increase in Miller's earnings contribution is primarily due to more large gas construction projects. Vectren's 100 percent ownership of Miller effective July 1, 2006 has also contributed to the year to date increase.

The results of Miller's operations have been included in consolidated results since July 1, 2006. While the acquisition of Miller did not have a material impact on the overall financial statements, consolidating Miller resulted in, among other impacts, a year to date increase of \$95.6 million in *Nonutility revenues* and a year to date increase of \$74.6 million in *Other operating expenses* in 2007 when compared to 2006.

The results of Miller's operations have been included in consolidated results since July 1, 2006. While the acquisition of Miller did not have a material impact on the overall financial statements, consolidating Miller resulted in, among other impacts, a year to date increase of \$95.6 million in *Nonutility revenues* and a year to date increase of \$74.6 million in *Other operating expenses* in 2007 when compared to 2006.

ESG's 2007 earnings were \$1.2 million in the third quarter, compared to \$2.1 million in 2006. Year to date, ESG earned approximately \$2.5 million in 2007 compared to \$2.2 million in 2006. The year to date increase is primarily due to higher revenues resulting from the December 31, 2006 backlog. These higher revenues were offset in the third quarter by the write-off of an investment. At September 30, 2007, ESG's backlog was \$64 million, compared to \$68 million at Dec. 31, 2006, and \$69 million at September 30, 2006.

### **Synfuel-Related Activity**

Pace Carbon Synfuels, LP (Pace Carbon) is a Delaware limited partnership formed to develop, own, and operate four projects to produce and sell coal-based synthetic fuel (synfuel) utilizing Covol technology. The Company has an 8.3 percent interest in Pace Carbon which is accounted for using the equity method of accounting. The Internal Revenue Code provides for manufacturers, such as Pace Carbon, to receive a tax credit for every ton of synthetic fuel sold. Under current tax laws, these synfuel related credits and fees cease at the end of 2007.

The Internal Revenue Service has issued private letter rulings, which concluded that the synthetic fuel produced at the Pace Carbon facilities should qualify for tax credits. The IRS has completed tax audits of Pace Carbon for the years 1998 through 2001 without challenging tax credit calculations. As a partner in Pace Carbon, Vectren has reflected synfuel tax credits in its consolidated results from inception through September 30, 2007, of approximately \$119 million, of which approximately \$108 million have been generated since 2001. To date, Vectren has been in a position to utilize or carryforward substantially all of the credits generated. Primarily from the use of these credits, the Company has an Alternative Minimum Tax (AMT) credit carryforward of approximately \$42 million at September 30, 2007.

Synfuel tax credits are only available when the price of oil is less than a base price specified by the Internal Revenue Code, as adjusted for inflation. The current forward price curve indicates that a phase out of synfuel tax credits in 2007 may occur. However, in the fourth quarter of 2006, the Company purchased oil contracts with a notional amount of 2.8 million barrels, which approximates the Company's expected 2007 synfuel production, to mitigate 2007 phase out risk. During the three and nine months ended September 30, 2007, the gains associated with these contracts totaled \$8.2 million and \$6.9 million, respectively, and are reflected in *Other-net*. Impairment charges related to the investment in Pace Carbon approximating \$9.5 million, or \$5.7 million after tax, were recorded in *Other-net* in the second quarter of 2006.

The investment in Pace Carbon resulted in losses reflected in *Equity in earnings of unconsolidated affiliates* totaling \$5.5 million and \$2.0 million for the three months ended September 30, 2007 and 2006, respectively, and \$16.1 million and \$14.0 million during the nine months ended September 30, 2007 and 2006, respectively. Synfuel-related

results, inclusive of those losses and their related tax benefits as well as the tax credits and other related activity, were earnings of \$3.5 million and \$8.3 million, respectively, for the three and nine months ended September 30, 2007 and 2006, respectively, compared to earnings of \$0.6 million and a loss of \$3.7 million, respectively, during the three and nine months ended September 30, 2006.

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**Impact of Recently Issued Accounting Guidance**

**FIN 48**

On January 1, 2007, the Company adopted FASB Interpretation No. 48 (FIN 48) “Accounting for Uncertainty in Income Taxes” an interpretation of SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of tax positions taken or expected to be taken in an income tax return. FIN 48 also provides guidance related to reversal of tax positions, balance sheet classification, interest and penalties, interim period accounting, disclosure and transition.

At adoption, the total amount of gross unrecognized tax benefits for uncertain tax positions, including positions impacting only the timing of tax benefits, was \$11.6 million. The accumulation of this amount resulted in an adjustment to beginning *Retained earnings* of \$0.1 million and to *Goodwill* of \$0.2 million.

**SFAS No. 157**

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; however, the standard will impact how other fair value based GAAP is applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company will adopt SFAS 157 on January 1, 2008, and is currently assessing the impact this statement will have on its financial statements and results of operations.

**SFAS 159**

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value. Items eligible for the fair value measurement option include: financial assets and financial liabilities with certain exceptions; firm commitments that would otherwise not be recognized at inception and that involve only financial instruments; nonfinancial insurance contracts and warranties that the insurer can settle by paying a third party to provide those goods or services; and host financial instruments resulting from separation of an embedded financial derivative instrument from a nonfinancial hybrid instrument. The fair value option may be applied instrument by instrument, with few exceptions, is an irrevocable election and is applied only to entire instruments. The Company will adopt SFAS 159 on January 1, 2008, and is currently assessing the impact this statement will have on its financial statements and results of operations.

**Financial Condition**

Within Vectren’s consolidated group, Utility Holdings funds the short-term and long-term financing needs of the Utility Group operations, and Vectren Capital Corp (Vectren Capital) funds short-term and long-term financing needs of the Nonutility Group and corporate operations. Vectren Corporation guarantees Vectren Capital’s debt, but does not guarantee Utility Holdings’ debt. Vectren Capital’s long-term and short-term obligations outstanding at September 30, 2007, totaled \$200 million and \$134.5 million, respectively. Utility Holdings’ outstanding long-term and short-term borrowing arrangements are jointly and severally guaranteed by Indiana Gas, SIGECO, and VEDO. Utility Holdings’ long-term and short-term obligations outstanding at September 30, 2007, totaled \$700 million and \$352.5 million,

respectively. Additionally, prior to Utility Holdings' formation, Indiana Gas and SIGECO funded their operations separately, and therefore, have long-term debt outstanding funded solely by their operations.

The Company's common stock dividends are primarily funded by utility operations. Nonutility operations have demonstrated sustained profitability, and the ability to generate cash flows. These cash flows are primarily reinvested in other nonutility ventures, but are also used to fund a portion of the Company's dividends, and from time to time may be reinvested in utility operations or used for corporate expenses.

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The credit ratings of the senior unsecured debt of Utility Holdings, SIGECO and Indiana Gas, at September 30, 2007, are A-/Baa1 as rated by Standard and Poor's Ratings Services (Standard and Poor's) and Moody's Investors Service (Moody's), respectively. The credit ratings on SIGECO's secured debt are A/A3. Utility Holdings' commercial paper has a credit rating of A-2/P-2. The current outlook of both Moody's and Standard and Poor's is stable. These ratings and outlooks have not changed since December 31, 2006. A security rating is not a recommendation to buy, sell, or hold securities. The rating is subject to revision or withdrawal at any time, and each rating should be evaluated independently of any other rating. Standard and Poor's and Moody's lowest level investment grade rating is BBB- and Baa3, respectively.

The Company's consolidated equity capitalization objective is 45-55% of long-term capitalization. This objective may have varied, and will vary, depending on particular business opportunities, capital spending requirements, execution of long-term financing plans and seasonal factors that affect the Company's operations. The Company's equity component was 49% and 48% of long-term capitalization at September 30, 2007, and December 31, 2006, respectively. Long-term capitalization includes long-term debt, including current maturities and debt subject to tender, as well as common shareholders' equity.

The Company expects the majority of its capital expenditures, investments, and debt security redemptions to be provided by internally generated funds. However, due to significant capital expenditures and expected growth in nonutility operations, the Company may require additional permanent financing, and currently has an equity forward contract outstanding as more fully described below. As of September 30, 2007, the Company was in compliance with all financial covenants.

### **Sources & Uses of Liquidity**

#### Operating Cash Flow

The Company's primary historical source of liquidity to fund working capital requirements has been cash generated from operations. While net income was up substantially, cash flow from operating activities of \$232.2 million decreased \$31.4 million during the nine months ended September 30, 2007, compared to 2006. The decrease was primarily a result of changes in working capital accounts and lower distributions from equity method investments compared to the prior year. Net income before non-cash charges of \$262.2 million increased \$46.3 million compared to the prior year. Working capital changes used cash of \$3.2 million in 2007 compared to cash generated of \$50.2 million in 2006. Distributions from equity method investments, which principally consist of dividends from ProLiance, were \$20.0 million in 2007 compared to \$33.5 million in 2006. Distributions in 2006 include a \$10.4 million special dividend from ProLiance.

#### Financing Cash Flow

Although working capital requirements are generally funded by cash flow from operations, the Company uses short-term borrowings to supplement working capital needs when accounts receivable balances are at their highest and gas storage is refilled. Additionally, short-term borrowings are required for capital projects and investments until they are financed on a long-term basis.

Cash flow required for financing activities of \$51.3 million for the nine months ended September 30, 2007, includes incremental short-term borrowings of \$21.9 million, \$10.4 million less than in the nine months ended September 30, 2006. Common stock dividends have increased over the prior period due to board authorized increases in the dividend rate.

#### Investing Cash Flow

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Cash flow required for investing activities was \$202.5 million for the nine months ended September 30, 2007, a decrease of \$37.2 million over the prior year. The decrease is attributable to the receipt of \$44.9 million in proceeds from the sale of SIGECOM, offset by an increase in electric transmission and pollution control capital expenditures.

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**Available Sources of Liquidity**

Short-term Borrowing Arrangements

At September 30, 2007, the Company has \$780 million of short-term borrowing capacity, including \$520 million for the Utility Group and \$260 million for the wholly owned Nonutility Group and corporate operations, of which approximately \$167 million is available for the Utility Group operations and approximately \$126 million is available for the wholly owned Nonutility Group and corporate operations.

Common Stock Offering

In February 2007, the Company sold 4.6 million authorized but previously unissued shares of its common stock to a group of underwriters in an SEC-registered primary offering at a price of \$28.33 per share. The transaction generated proceeds, net of underwriting discounts and commissions, of approximately \$125.7 million. The Company executed an equity forward sale agreement (equity forward) in connection with the offering, and therefore, did not receive proceeds at the time of the equity offering. The equity forward allows the Company to price an offering under market conditions existing at that time, and to better match the receipt of the offering proceeds and the associated share dilution with the implementation of regulatory initiatives, providing a return on the new equity employed. The offering proceeds, when and if received, will be used to permanently finance primarily electric utility capital expenditures.

In connection with the equity forward, an affiliate of one of the underwriters (the forward seller), at the Company's request, borrowed an equal number of shares of the Company's common stock from institutional stock lenders and sold those borrowed shares to the public in the primary offering. The Company will receive an amount equal to the net proceeds from that sale, subject to certain adjustments defined in the equity forward, upon full share settlement of the equity forward. Those adjustments defined in the equity forward include 1) daily increases in the forward sale price based on a floating interest factor equal to the federal funds rate, less a 35 basis point fixed spread, and 2) structured quarterly decreases to the forward sale price that align with expected Company dividend payments.

The Company may elect to settle the equity forward in shares or in cash, except in specified circumstances or events where the counterparty to the equity forward could force a share settlement. Examples of such events include, but are not limited to, the Company making dividend payments greater than the structured quarterly decreases identified in the equity forward or the Company repurchasing a number of its outstanding common shares over a specified threshold. If the Company elects to settle in shares, the maximum number of shares deliverable by the Company is 4.6 million shares. If the Company elects to settle in cash, an affiliate of one of the underwriters (the forward purchaser) would purchase shares in the market and return those shares to the stock lenders. The Company will either owe or be owed funds depending upon the Company's average share price during the "unwind period" defined in the equity forward in relation to the equity forward's contracted price. Generally, if the equity forward's contracted price is lower than the average share price during the "unwind period", then the Company would owe cash; and if the average share price during the "unwind period" is less than the equity forward's contracted price, the Company would receive cash. Proceeds received or paid when the equity forward is settled will be recorded in *Common Shareholders' Equity*, even if settled in cash. The equity forward must be settled prior to February 28, 2009.

The equity forward had an initial forward price of \$27.34 per share, representing the public offering price of \$28.33 per share, net of underwriting discounts and commissions. Management therefore estimated the contract had no initial fair value. If the equity forward had been settled by delivery of shares at September 30, 2007, the Company would have received approximately \$126.5 million based on a forward price of \$27.50 for the 4.6 million shares. If the Company had elected to settle the equity forward in cash at September 30, 2007, the Company estimates it would have received approximately \$3 million, assuming the price in the "unwind period" approximates the trailing three month average of Vectren's stock price. The federal funds rate was 5.25% at September 30, 2007. The Company currently

anticipates settling the equity forward by delivering shares.

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New Share Issues

The Company may periodically issue new common shares to satisfy dividend reinvestment plan, stock option plan, and other employee benefit plan requirements. New share issuances have added additional liquidity of \$5.2 million year to date in 2007.

Utility Holdings

Utility Holdings filed a shelf registration statement with the Securities and Exchange Commission for \$300 million aggregate principal amount of unsecured senior notes in September 2007, which is anticipated to meet Utility Holdings' estimated debt financing requirements over the next 3 years. In October 2007 the SEC declared the registration statement to be effective. When issued, the unsecured notes will be guaranteed by Utility Holdings' three operating utility companies: SIGECO, Indiana Gas, and VEDO. These guarantees of Utility Holdings' debt will be full and unconditional and joint and several.

**Potential Uses of Liquidity**

Planned Capital Expenditures & Investments

Investments in total company capital expenditures and nonutility unconsolidated affiliates for the remainder of 2007 are estimated to approximate \$109 million.

Other Guarantees and Letters of Credit

In the normal course of business, Vectren issues guarantees to third parties on behalf of its unconsolidated affiliates. Such guarantees allow those affiliates to execute transactions on more favorable terms than the affiliate could obtain without such a guarantee. Guarantees may include posted letters of credit, leasing guarantees, and performance guarantees. As of September 30, 2007, guarantees issued and outstanding on behalf of unconsolidated affiliates approximated \$3.0 million. The Company has accrued no liabilities for these guarantees as they relate to guarantees issued among related parties.

In 2006, the Company issued a guarantee with an approximate \$5.0 million maximum risk related to the residual value of an operating lease that expires in 2011. As of September 30, 2007, Vectren Corporation has a liability representing the fair value of that guarantee of less than \$0.1 million. Liabilities accrued for, and activity related to, product warranties are not significant. Through September 30, 2007, the Company has not been called upon to satisfy any obligations pursuant to its guarantees.

Table of Contents**Forward-Looking Information**

A “safe harbor” for forward-looking statements is provided by the Private Securities Litigation Reform Act of 1995 (Reform Act of 1995). The Reform Act of 1995 was adopted to encourage such forward-looking statements without the threat of litigation, provided those statements are identified as forward-looking and are accompanied by meaningful cautionary statements identifying important factors that could cause the actual results to differ materially from those projected in the statement. Certain matters described in Management’s Discussion and Analysis of Results of Operations and Financial Condition are forward-looking statements. Such statements are based on management’s beliefs, as well as assumptions made by and information currently available to management. When used in this filing, the words “believe”, “anticipate”, “endeavor”, “estimate”, “expect”, “objective”, “projection”, “forecast”, “goal” and similar expressions are intended to identify forward-looking statements. In addition to any assumptions and other factors referred to specifically in connection with such forward-looking statements, factors that could cause the Company’s actual results to differ materially from those contemplated in any forward-looking statements include, among others, the following:

- Factors affecting utility operations such as unusual weather conditions; catastrophic weather-related damage; unusual maintenance or repairs; unanticipated changes to fossil fuel costs; unanticipated changes to gas supply costs, or availability due to higher demand, shortages, transportation problems or other developments; environmental or pipeline incidents; transmission or distribution incidents; unanticipated changes to electric energy supply costs, or availability due to demand, shortages, transmission problems or other developments; or electric transmission or gas pipeline system constraints.
  - Increased competition in the energy environment including effects of industry restructuring and unbundling.
- Regulatory factors such as unanticipated changes in rate-setting policies or procedures, recovery of investments and costs made under traditional regulation, and the frequency and timing of rate increases.
- Financial, regulatory or accounting principles or policies imposed by the Financial Accounting Standards Board; the Securities and Exchange Commission; the Federal Energy Regulatory Commission; state public utility commissions; state entities which regulate electric and natural gas transmission and distribution, natural gas gathering and processing, electric power supply; and similar entities with regulatory oversight.
- Economic conditions including the effects of an economic downturn, inflation rates, commodity prices, and monetary fluctuations.
- Increased natural gas commodity prices and the potential impact on customer consumption, uncollectible accounts expense, unaccounted for gas and interest expense.
- Changing market conditions and a variety of other factors associated with physical energy and financial trading activities including, but not limited to, price, basis, credit, liquidity, volatility, capacity, interest rate, and warranty risks.
- The performance of projects undertaken by the Company’s nonutility businesses and the success of efforts to invest in and develop new opportunities, including but not limited to, the realization of synfuel income tax credits and the Company’s coal mining, gas marketing, and energy infrastructure strategies.
- Direct or indirect effects on the Company’s business, financial condition, liquidity and results of operations resulting from changes in credit ratings, changes in interest rates, and/or changes in market perceptions of the utility industry and other energy-related industries.
- Employee or contractor workforce factors including changes in key executives, collective bargaining agreements with union employees, aging workforce issues, or work stoppages.
- Legal and regulatory delays and other obstacles associated with mergers, acquisitions and investments in joint ventures.
- Costs, fines, penalties and other effects of legal and administrative proceedings, settlements, investigations, claims, including, but not limited to, such matters involving inadvertent violations of state and federal laws.
- Changes in federal, state or local legislative requirements, such as changes in tax laws or rates, environmental laws, including laws governing greenhouse gases, and other regulations.

*The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of changes in actual results, changes in assumptions, or other factors affecting such statements.*

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company is exposed to various business risks associated with commodity prices, interest rates, and counter-party credit. These financial exposures are monitored and managed by the Company as an integral part of its overall risk management program. The Company's risk management program includes, among other things, the use of derivatives. The Company also executes derivative contracts in the normal course of operations while buying and selling commodities to be used in operations and optimizing its generation assets.

The Company has in place a risk management committee that consists of senior management as well as financial and operational management. The committee is actively involved in identifying risks as well as reviewing and authorizing risk mitigation strategies.

These risks are not significantly different from the information set forth in Item 7A Quantitative and Qualitative Disclosures About Market Risk included in the Vectren 2006 Form 10-K and are therefore not presented herein.

**ITEM 4. CONTROLS AND PROCEDURES**

**Changes in Internal Controls Over Financial Reporting**

During the quarter ended September 30, 2007, there have been no changes to the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

As of September 30, 2007, the Company conducted an evaluation under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer of the effectiveness and the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective as of September 30, 2007, to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is:

- 1) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and
- 2) accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The Company is party to various legal proceedings arising in the normal course of business. In the opinion of management, there are no legal proceedings pending against the Company that are likely to have a material adverse effect on its financial position. See the notes to the consolidated condensed financial statements regarding investments in unconsolidated affiliates, commitments and contingencies, environmental matters, and rate and regulatory matters. The consolidated condensed financial statements are included in Part 1 Item 1.

**ITEM 1A. RISK FACTORS**

The Company's risk factors have not changed from the information set forth in Item 1A Risk Factors included in the Vectren 2006 Form 10-K and are therefore not presented herein.



Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Periodically, the Company purchases shares from the open market to satisfy share requirements associated with the Company's share-based compensation plans. The following chart contains information regarding open market purchases made by the Company to satisfy share-based compensation requirements during the quarter ended September 30, 2007.

Period	Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares That May Be Purchased Under These Plans
July 1-31	-	-	-	-
August 1-31	-	-	-	-
September 1-30	8,500	27.13	-	-

**ITEM 6. EXHIBITS****Exhibits and Certifications**

31.1 Certification Pursuant To Section 302 of The Sarbanes-Oxley Act Of 2002- Chief Executive Officer

31.2 Certification Pursuant To Section 302 of The Sarbanes-Oxley Act Of 2002- Chief Financial Officer

32 Certification Pursuant To Section 906 of The Sarbanes-Oxley Act Of 2002



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VECTREN  
CORPORATION  
Registrant

November 2, 2007

/s/Jerome A. Benkert, Jr.  
Jerome A. Benkert, Jr.  
Executive Vice President & Chief Financial Officer  
(Principal Financial Officer)

/s/M. Susan Hardwick  
M. Susan Hardwick  
Vice President, Controller & Assistant Treasurer  
(Principal Accounting Officer)